

The background features a vertical gradient from dark teal on the left to bright yellow on the right. Overlaid on this are several concentric, semi-transparent circular arcs in shades of green and yellow, creating a sense of depth and movement. A horizontal, semi-transparent yellow band passes through the center of the composition.

Defining Direction



Defining Direction

**First Pakistan
Islamic Banking &
Money Market Conference**

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Musharaka

The term “Musharaka” has been derived from the Islamic fiqh concept of “Shirkah” which means sharing or partnership.

1. Shirkat-ul-Milk: means joint ownership between two or more persons or parties in a particular property or asset, which may not necessarily be for earning profit.

2. Shirkat-ul-Aqd: means a contract between two or more persons or parties participating for a common business objective. The sole purpose being to share profits and losses arising from a the jointly owned enterprise in accordance with the principles of Shariah.



Home Mortgage

- In Pakistan “Islamic Home Finance” is generally based on Diminishing Musharaka mode of Islamic finance.
- Diminishing Musharaka refers to a partnership established under a contract, by the mutual consent of the parties for joint ownership of the property.
- Diminishing Musharaka home finance allows equity-type participation for the bank and then allows the bank to rent out its share of the property to the client.
- In addition the client undertakes to buy the equity of the bank and ultimately becomes the sole owner of the asset.



- ❑ The customer approaches the Bank with the request for Home financing
- ❑ The Bank enters into a Musharakah (Joint Ownership) agreement with the customer and both of them pay their respective shares to the seller of the asset.
- ❑ Customer pays rent for the use of banks share in the property
- ❑ Ownership of the asset is gradually transferred to the customer upon payment of asset price.

Steps	Particulars	Document
1	Bank and the client will enter into a Musharakah Agreement (to jointly purchase & own the Property) and the client will agree to lease Banks undivided share in the Property for an agreed period, based on certain terms and conditions.	Musharakah Agreement
2	The Property will be registered in the name of the client and an equitable mortgage will be created over the Property in the name of the Bank.	Memorandum of Deposit of Title Deed
3	The client will undertake to buy the undivided share in the Property over an agreed period, based on certain terms and conditions.	Purchase Undertaking
4.	On maturity, client would have acquired all the shares of the Bank whereby the bank would release the equitable mortgage. The client would become the sole owner of the Property	Mortgage Redemption Instrument

Why is Property registered in client's name?

- The local regulations do not permit banks to own property for investment purposes.
- In addition every time a property is sold the buyer has to pay a high cost of registration- Double Taxed
- However, according to Islamic Shariah law, there has to be a joint ownership for which the bank signs a legally binding Musharakah (joint ownership) agreement with the client.
- In order to protect the bank's ownership in the property, the client has to create a mortgage on the property in favor of the Islamic Bank.

What will be a Musharakah unit?

Total value of the property	Rs. 10,000,000
Banks share of financing	Rs. 8,000,000
Rate of rental	9%
Tenor	20 yrs

Example

$$\frac{\text{Rs. 8,000,000 (Banks share)}}{240 \text{ (Tenor)}} = \text{Rs. 33,333 (Cost of One Musharakah Unit)}$$

Bank's share of the rent will be determined as follows

Monthly Rent

Total Value of the property X **Banks Investment in the Property** = **Banks share in monthly Rent**

Example

Rs 75,000
Rs 10,000,000 X Rs 8,000,000 = 60,000

Based on the above example, the first monthly installment will be Rs 93,333 (rent + price of one unit). This installment will reduce monthly as the client will buy one unit every month. His share in the property will grow and accordingly his rentals will reduce.

Home Finance (Diminishing Musharaka)

The Bank effectively becomes an equity partner with the customer and buys a property on a joint ownership. Every month, in addition to the customer paying rent to the Bank for the usage and occupation of the bank's shares in the property. He also buys back a certain share of the property every month and by the end of the tenure, the customer has bought over the entire property from the Bank and becomes the Sole Owner.

Property Price	1,000,000
No. of shares	20
Price of Share	50,000
Length of Contract	12 months
IRR	9%
Rental per share/per month	375
Percent Financed	60%
Amount Financed	600,000

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	D
Customer	Shares	8	9	10	11	12	13	14	15	16	17	18	19
	% Equity	40%	45%	50%	55%	60%	65%	70%	75%	80%	85%	90%	95%
Bank	Shares	12	11	10	9	8	7	6	5	4	3	2	1
	% Equity	60%	55%	50%	45%	40%	35%	30%	25%	20%	15%	10%	5%

		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	D	
Payments	Share Price	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	600,000
	Rental	4,500	4,125	3,750	3,375	3,000	2,625	2,250	1,875	1,500	1,125	750	375	29,250
	Total	54,500	54,125	53,750	53,375	53,000	52,625	52,250	51,875	51,500	51,125	50,750	50,375	629,250

Amortization Table Diminishing Musharakah Basis

Value	10,000,000	Rate	9%
Bank's Share	8,000,000	Rent pm	75,000
Total Units	300	Bank's share	60,000
Bank owned	240	unit/month	250
Price per uni	33,333.33		
Tenor	20 yrs		
No. of Instal.	240		

Month	Due Date	Rental	Principal	Installment Amount	O/S Principal
1	31-Jan-1900	60,000	33,333	93,333	7,966,667
2	02-Mar-1900	59,750	33,333	93,083	7,933,333
3	02-Apr-1900	59,500	33,333	92,833	7,900,000
4	02-May-1900	59,250	33,333	92,583	7,866,667
5	02-Jun-1900	59,000	33,333	92,333	7,833,333
6	02-Jul-1900	58,750	33,333	92,083	7,800,000
7	02-Aug-1900	58,500	33,333	91,833	7,766,667
8	02-Sep-1900	58,250	33,333	91,583	7,733,333
9	02-Oct-1900	58,000	33,333	91,333	7,700,000
10	02-Nov-1900	57,750	33,333	91,083	7,666,667
230	01-Aug-2024	2,750	33,333	36,083	333,333
231	01-Sep-2024	2,500	33,333	35,833	300,000
232	01-Oct-2024	2,250	33,333	35,583	266,667
233	01-Nov-2024	2,000	33,333	35,333	233,333
234	01-Dec-2024	1,750	33,333	35,083	200,000
235	01-Jan-2025	1,500	33,333	34,833	166,667
236	01-Feb-2025	1,250	33,333	34,583	133,333
237	01-Mar-2025	1,000	33,333	34,333	100,000
238	01-Apr-2025	750	33,333	34,083	66,667
239	01-May-2025	500	33,333	33,833	33,333
240	01-Jun-2025	250	33,333	33,583	0

Amortization, Installment Constant

Loan Amount	8,000,000.00	Rate	9%
Draw Dawn	Full	Start Date	01-Aug-2005
Tenor	20	End Date	01-Aug-2025
No. of Instal.	240	EMI	71,978.08
		Penalty Rate	

Month	Due Date	Rental	Principal	Installment Amount	O/S Principal
1	01-Sep-2005	60,000.00	11,978.08	71,978.08	7,988,021.92
2	01-Oct-2005	59,910.16	12,067.91	71,978.08	7,975,954.01
3	01-Nov-2005	59,819.66	12,158.42	71,978.08	7,963,795.59
4	01-Dec-2005	59,728.47	12,249.61	71,978.08	7,951,545.98
5	01-Jan-2006	59,636.59	12,341.48	71,978.08	7,939,204.50
6	01-Feb-2006	59,544.03	12,434.04	71,978.08	7,926,770.46
7	01-Mar-2006	59,450.78	12,527.30	71,978.08	7,914,243.16
8	01-Apr-2006	59,356.82	12,621.25	71,978.08	7,901,621.91
9	01-May-2006	59,262.16	12,715.91	71,978.08	7,888,905.99
10	01-Jun-2006	59,166.79	12,811.28	71,978.08	7,876,094.71
230	01-Oct-2024	5,679.43	66,298.64	71,978.08	690,959.27
231	01-Nov-2024	5,182.19	66,795.88	71,978.08	624,163.39
232	01-Dec-2024	4,681.23	67,296.85	71,978.08	556,866.54
233	01-Jan-2025	4,176.50	67,801.58	71,978.08	489,064.96
234	01-Feb-2025	3,667.99	68,310.09	71,978.08	420,754.87
235	01-Mar-2025	3,155.66	68,822.41	71,978.08	351,932.46
236	01-Apr-2025	2,639.49	69,338.58	71,978.08	282,593.88
237	01-May-2025	2,119.45	69,858.62	71,978.08	212,735.25
238	01-Jun-2025	1,595.51	70,382.56	71,978.08	142,352.69
239	01-Jul-2025	1,067.65	70,910.43	71,978.08	71,442.26
240	01-Aug-2025	535.82	71,442.26	71,978.08	0.00
		9,274,738.35	8,000,000.00	17,274,738.35	

Risk Mitigation and Documentation

- 1 Islamic Housing Finance Musharaka Agreement
- 2 Monthly Payment Agreement
- 3 Undertaking by the client to purchase Musharaka units
- 4 Undertaking by the bank to sell Musharaka units



Islamically
Structured
Documents

- 5 Memorandum of deposit of Title Deed
- 6 Irrevocable General Power of attorney
- 7 Demand Promissory note



Conventional
Mortgage
Documents



Late Payment

- **As in Islamic Shariah, late payment fee cannot be charged and booked in banks P&L.**
- **To discourage late payment; in case of a late payment, the client has to pay a certain amount in a charity fund (maintained by the bank) according to his undertaking in the Musharakah agreement.**
- **Subject to Shariah Board approval, the bank may deduct a certain amount to cover the administrative costs relating to late payment recovery process.**



Equity Investment Risk

- The Bank is not exposed to any price devaluation risk. The client is liable to buy out the banks investment at the pre-agreed price and as per the agreed schedule.
- Another mitigant is that the Loan to Value is maximum 85% of the property value which addresses price fluctuations.

Default Risk

Client defaults on his rental payments

Mitigant

- Mortgage by deposit of title deeds will be created in favor of the bank.
- Client will furnish an irrevocable power of attorney in favor of the bank.
- **Events of Default** should be clearly defined in the 'Islamic Housing Finance Agreement'. In the event of default bank will issue a notice of termination to the client upon which the client would have to buy out the face value of banks share of the property pursuant to the Purchase Undertaking.
- Hence this liability would become a conventional Debt and would be claimable in the banking court as a debt. Financial Institutions (recovery of Finances) Ordinance 2001, section 15. (The same ordinance which administer conventional banking facilities).

Capital Impairment Risk

- If the mortgaged property gets totally destroyed because of factors beyond the control of the client.
- **Mitigant** Mandatory requirement for the client to obtain insurance/Takaful coverage (for property and life).
- The Bank also has recourse to the land.



Reputational Risk

Islamic Bank fails to comply with Shariah rules and principles, (This can cause serious confidence problems which may result in deposit withdrawals or loss of income. This may also erode reputation as a provider of true Islamic offerings).

- **Mitigant:** Bank should have adequate systems and controls in place, including global Shariah Advisory Board as well as a local Shariah advisor for day to day advisory, to ensure compliance with Shariah rules and principles.
 - A well-defined, adequately qualified and staffed, organizational structure.
 - The Shariah advisor will periodically audit any product/portfolio.
 - Provide approvals for deviations (if any)
 - A Software will be in place to ensure proper accounting and GL maintenance
- Islamic Bank will undertake a Shariah compliance review at least annually, performed by Shariah Advisory Board or external audit function, having required knowledge and expertise.