

COMPARISON OF DIMINISHING MUSHARAKA AND CONVENTIONAL HOUSE FINANCING CONTRACTS

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Methodology:

This paper compares diminishing musharaka and conventional house financing contracts as formulated by banks in Karachi in mid 2006. The following aspects of the diminishing musharaka and conventional house financing contracts have been compared.

- 1- Commencement of agreement
- 2- Termination of contract
- 3- Risk of loss
- 4- Ownership provision
- 5- Sale transfer
- 6- Expense consequent to ownership

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- 7- Security
- 8- Liability of bank / clients

- 9- Rights of bank / clients
- 10-Penalty on late payment

I have also compared the following terms and conditions of the contracts.

- 1- Rate of return for salaried clients
- 2- Rate of return for businessmen
- 3- Age of salaried clients
- 4- Age of business clients
- 5- Income (minimum) required
- 6- Tenure
- 7- Amount (minimum and maximum) of advance
- 8- Debt equity ratio
- 9- Insurance
- 10-Processing fee
- 11-Mortgage deed
- 12- Bank statement requirements for salaried clients
- 13- Bank statement requirement for businessmen
- 14- Copy of NIC and passport size photographs
- 15- Business proves and job proves

I visited 10 banks: four Islamic banks and six conventional banks for obtaining Diminishing Musharaka house financing and conventional house financing contracts in mid 2006. These included,

- 1. Standard Chartered (Islamic Bank)
- 2. Faysal Islamic Bank
- 3. Meezan Bank
- 4. ALBaraka Islamic Bank
- 5. MCB
- 6. Mybank Bank Limited
- 7. Allied Bank Limited
- 8. National Bank of Pakistan
- 9. Standard Chartered (Conventional)
- 10- Bank Al-Habib

Contracts were obtained from three Islamic banks and three conventional banks, I also collected data from these six banks through interviews of executives. These banks are,

- 1. Standard Chartered (Islamic Bank)
- 2. Meezan Islamic Bank

3. ALBaraka Islamic Bank
4. Mybank (Conventional)
5. MCB
6. Standard Chartered (Conventional)

Analysis of Differences in Contracts of Diminishing Musharaka house financing and conventional house financing contracts in Karachi.

1-Commencement of agreement:

Diminishing Musharaka house financing contract.

The contract of Diminishing Musharaka house financing can be effected for a future date on the condition that the “profit” rate is payable after possession of the house by the client. Thus an effective forward contract is allowed despite its prohibition in Islam. It is called “a later” contract by the Islamic bank. Repayment of principal and “profit” / rent becomes due on possession of property by the client.

Conventional house financing contract.

The contract of conventional house financing can be effected from the first day of the agreement without the client’s possession of the property.

2-Termination of contract:

Diminishing Musharaka house financing contract.

(a) If the financier contravenes any term of the agreement, the client has the right to terminate the Musharaka contract unilaterally. If there is no contravention on the part of the financier, the contract cannot be terminated without mutual consent by the client. The bank can terminate the contract without mutual consent, if the client does not pay “profit” on time, and he is not able to buy the shares of the bank according to schedule.

(b) In case of the death of the client the contract will be terminated and it will be renewable by his successors.

(c) The client can terminate contract by purchasing the shares of the bank.

Conventional house financing termination of contract.

(a) The client can terminate the contract unilaterally if the bank contravenes any terms of the contract. The bank also has right to terminate the contract unilaterally, if the client contravenes any terms of the contract. Without mutual consent the

bank can also terminate the contract, if the borrower is not able to pay interest with principal according to payment schedule.

(b) In case of death of the client the contract will be terminated, it is renewable by his successors.

(c) Client can terminate the contract by paying the whole principal and interest due at any time.

3-Risk of loss:

Diminishing Musharaka house financing contract.

In the Diminishing Musharaka house financing contract the financier as a Shirkat-ul-Milk participates in “profit” not in loss, the client will participate in both “profit” and loss, and the client will bear all losses.

Conventional house financing contract.

In the conventional house financing contract, there is no “profit and loss” agreement between the bank and the client. The client suffers losses,. Losses can occur due to improper location, insufficient material employed in building, other technical problems and improper care.

4-Ownership provision:

Diminishing Musharaka house financing contract.

In the Diminishing Musharaka house financing contract the bank and the client co-own the house according to a predetermined ratio, if the bank invests 80% and the client invests 20%, the bank will own 80% of the property.

Conventional house financing contract.

In a conventional house financing contract, the client has ownership, but his property papers remain in the bank until after paying of all scheduled amounts. Conventional banks prefer simple and registered mortgages.

5- Sale Transfer:

Diminishing Musharaka house financing contract.

In Diminishing Musharaka house financing contracts, the client and the bank jointly buy the house on the basis of a debt equity ratio, usually (80:20 or 60:40). The bank divides its equity shares into equal units. The bank makes an agreement to allow the client to buy the units periodically, thus reducing the share of the bank and increasing the share of the client.

This arrangement allows the bank to claim “rent” according to its proportion of ownership in the property and at the same time allows a periodical return of a part of the

principal through purchase of the units of the bank’s share of the house by the client.

Conventional house financing contract.

In conventional house financing contract the client is the sole owner of the property, the bank has the mortgage deed of the client’s property. The bank divides its loan into equal installments with fixed

interest rate. Thus the client pays principal plus interest periodically. After completion of installments in the required period, the bank releases the mortgaged documents to the client.

6-Expense consequent to ownership:
Diminishing Musharaka house financing contract.

In Diminishing Musharaka house financing contract the client pays all expenses consequent to ownership, the bank participates in “profit” not in expenses or losses.

Conventional house financing contract.

In conventional house financing contract the client pays all the expenses consequent to ownership. Conventional banks do not incur any expenses.

7- Security:
Diminishing Musharaka house financing.

Standard Chartered (Islamic banking) requires mortgage of the client’s part of the house, which the bank and the client buy jointly. Meezan Bank and AlBaraka require mortgage deeds. They prefer simple and registered mortgages.

Conventional house financing contracts.

Conventional banks require memorandum of title deed and mortgage deed of the house which is going to be financed. Conventional banks also prefer simple and registered mortgages.

8- Liability of bank and client:
Diminishing Musharaka house financing contract.

In Diminishing Musharaka house financing contracts the bank is liable for complying with the terms of the agreements. These include payments according to pre-determined schedules and sale of its share to the client. At the time of agreement the bank must disclose all facts pertinent to the agreement before the agreement is enacted.

The client is also liable for complying with the terms of the agreements. He is responsible for investing according to the mutual agreed “debt” equity ratio, buy unit shares of the bank periodically according to schedule pay “profit” rate on time, disclose all facts before agreement.

Conventional project financing.

In conventional house financing contracts the bank is liable for complying with the terms of the agreement as is the client.

9- Rights of bank and client:
Diminishing Musharaka house financing.

In Diminishing Musharaka house financing contracts the following are the rights and the powers of partners.

(a) The bank and the client cannot sell their undivided shares of the property. Islamic banks in Pakistan do not recognize the right of the client to sell his share of the property.

- (b) The bank has the right to charge penalty on late payment. It has the right to sell the house if the client is not able to buy unit shares of the bank, according to schedule.
- (c) The client has the right to become a sole owner of the house after buying the full share of the bank.

Conventional house financing.

In a conventional house financing contract the following are rights and powers of the bank and the client.:

- (a) The bank has the right to auction the property, if the client defaults.
- (b) The client has the right to get his mortgage released from the bank through paying off his debt.

10- Penalty for Late Charge: Diminishing house financing contract.

In Diminishing Musharaka house financing contracts the bank is entitled to charge penalty on late payments. Standard Chartered (Islamic bank), Meezan and Alabaraka charge penalty after 45 days.

If the client makes late payments, the bank will continuously charge penalty.

Conventional house financing contract.

In traditional house financing the bank is entitled to charge penalty on late payments after 45 days.

Table 1 summarizes terms and condition of both types of contracts in Karachi in mid 2006.

No	Terms and conditions	Standard Chartered (Islamic Banking)	Meezan Bank	ALBaraka Islamic Bank	Mybank	Standard Chartered (Traditional)	MCB
1	Rate "Profit" Interest for (Salaried) clients	14% to 15%	15%	12%	12%	14.45%	11%
2	Rate "Profit" Interest for Businessmen	14% to 15%	17%	12%	12%	14.95%	11%
3	Age of borrower (Salaried)	25 to 65 years	25 to 65 years	25 to 60 years	25 to 65 years	25 to 65 years	25 to 65 years
4	Age of borrower (Businessmen)	25 to 65 years	25 to 65 years	25 to 60 years	25 to 65 years	25 to 65 years	25 to 65 years
5	Income (min)	Rs. 20000	Rs. 25000	Rs. 20000	Rs. 20000	Rs.20000 (Salaried) Rs.50000	Rs. 18000

						(Businessmen)	
6	Tenure	1 to 10 years	1 to 15 years	3 to 20 years	3 to 15 years	3 to 20 years	3 to 20 years
7	Amount min / max	Rs 300,000 to Rs 20 million	Rs 400,000 to Rs 20 million	Rs 500,000 to Rs 20 million	Rs 300,000 to Rs 20 million	Rs 300,000 to Rs 25 million	Rs 500,000 to Rs 20 million
8	Debt equity ratio	60 : 40	80:20	80:20	60:40	60:40	80:20
9	Insurance	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory
10	Processing fees	Rs 15000	Rs 21000	Rs 10000	Rs 12000	Rs 15000 or above	Rs 11000
11	Mortgage deed required	Yes	Yes	Yes	Yes	Yes	Yes
12	Bank statement for Salaried client required	6 months	6 months	6 months	6 months	6 months	6 months
13	Bank statement for Business clients required	1 Year	1 Year	1 Year	1 Year	1 Year	1 Year
14	Copy of NIC, Passport size Photo graphs required	Yes	Yes	Yes	Yes	Yes	Yes
15	Business Proof and job proof.	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory

It can be seen that,

**1-Fixed rate:
Diminishing Musharaka house financing.**

Standard Chartered (Islamic banking) offers Diminishing Musharaka house finance to consumers for buying a house, at the fixed “profit” rate of 14% for salaried clients and 14% to 15% for businessmen and offers “rent” pricing options for 1,3,5,10 year periods. The client has the option to agree to a fixed rate of “profit” for 1 year. After one year the fixed rate of “profit” can be changed. Meezan Bank offers similar financing at the fixed “profit” rate of 15% for salaried persons and 17% for businessmen, there is also an option available for fixing the “profit” rate for 3,5,10 years, AlBaraka also offers Diminishing Musharaka house financing at 12% fixed rate available for salaried persons and businessmen. It does not offer rent pricing options for fixing the profit rate.

Conventional house financing.

In conventional house financing Mybank offers conventional house financing with fixed interest rate of 12% for salaried persons as well as for businessmen. Standard Chartered (conventional bank) offers house financing at the fixed interest rate of 14.45% for salaried persons and 14.95% for businessmen. MCB offers house financing at fixed interest rate of 11% for salaried persons and for businessmen.

2- Age:

Diminishing Musharaka house financing.

Standard Chartered (Islamic Bank) requires age limit for Diminishing musharaka house financing borrowers of 25 to 65 years for salaried persons and 25 to 65 years for businessmen. Meezan Bank requires age limit 25 to 65 years for salaried persons and businessmen. AlBaraka Islamic Bank requires age limit of 25 to 60 years for salaried persons as well as businessmen.

Conventional house financing.

In case of conventional banks, My bank requires age limit for conventional house financing of 25 to 65 years for salaried persons and businessmen. Standard Chartered (conventional bank) requires age limit of 25 to 65 years for salaried persons and businessmen. MCB requires age limit of 22 to 65 years for salaried persons and 21 to 65 years for businessmen.

3- Income:

Diminishing Musharaka house financing.

Standard Chartered (Islamic Banking) requires minimum income per month to be Rs 20000 for both salaried persons and businessmen. Meezan Islamic bank requires minimum income per month to be Rs. 25000 for both salaried persons and businessmen. ALBaraka Islamic bank requires a minimum income of Rs. 20000 for salaried persons and businessmen.

Conventional house financing.

In case of conventional house financing, MyBank requires minimum income of Rs 20000 per month for salaried persons as well as businessmen. Standard Chartered (Conventional banking) requires minimum income of Rs 20000 per month for salaried persons and Rs 50000 for businessmen. MCB requires minimum income of Rs 18000 per month for both salaried persons and businessmen.

4-Tenure:

Diminishing Musharaka house financing.

Standard Chartered (Islamic bank) offers Diminishing Musharaka house financing for a duration of one to ten years. Meezan Islamic bank offers 3 to 15 years. AlBaraka Islamic bank offers 3 to 20 years.

Conventional house financing.

In conventional house financing, MyBank offers house financing for the duration of 3 to 15 years. Standard Chartered offers house financing for the duration of 3 to 20 years and MCB offers a duration period of 3 to 20 years.

5- Amount:

Diminishing Musharaka house financing.

Standard Chartered provides Diminishing Musharaka house financing amount from Rs 300,000 to Rs 20 million and Meezan Bank provides amounts of Rs 400000 to Rs 20 million. AlBaraka Islamic Bank provides Rs 500000 to Rs 20 million.

Conventional house financing:

Mybank provides house financing amount ranging from for Rs 300000 to Rs 20 million. MCB offers house financing for minimum amount of Rs 500000 to a maximum of Rs 20 million and Standard Chartered Conventional's financing ranges from Rs 300000 to Rs 25 million.

6-Debt-equity ratio:

Diminishing Musharaka house financing.

Standard Chartered (Islamic banking) offers Diminishing Musharaka house financing at 60:40 "debt" equity ratio, and Meezan bank offers house financing at 80:20 "debt" equity ratio. AlBaraka Islamic bank offers similar product at 80:20 "debt" equity ratio.

Conventional house financing:

Mybank offers house financing at 60:40 debt-equity ratio, Standard Chartered (Conventional bank) offers house financing at 60:40 debt-equity ratio, and MCB offers conventional financing at 80:20 debt-equity ratio.

7-Insurance:

Is mandatory for both types of contracts for all banks.

8-Processing fee:

Diminishing Musharaka house financing.

Standard Chartered (Islamic banking) charges Rs 15000 for processing fee including appraisal fee and lawyer fee's and Meezan Bank charges Rs 21000 for processing fee, AlBaraka charges Rs 10000 as processing fee.

Conventional house financing.

Mybank charges Rs 12000 for processing fee. MCB charges Rs 11000 for processing fee and Standard Chartered (conventional bank) charges Rs 15000 for processing fee.

9-Mortgage Deed:

Diminishing Musharaka house financing.

Standard Chartered (Islamic banking) requires mortgage deed for the client's part of a house, Meezan Bank and AlBaraka also require mortgage deed of the client's part of the house.

Conventional house financing.

Traditional banks require memorandum of title deed and mortgage deed.

10-Bank Statement:
Diminishing Musharaka house financing.

Standard Chartered (Islamic bank) requires 6 months bank statement for salaried individuals and 1 year bank statement for businessmen. Meezan Bank requires 6 months bank statement for salaried persons and 1 year statement for businessmen and Albaraka requires 4 months bank statement for salaried persons and 1 year bank statement for businessmen.

Conventional house financing.

MyBank requires 6 months bank statement for salaried persons and 1 year bank statement for businessmen. MCB bank requires 6 months bank statement for salaried persons and 1-year bank statement for businessmen. Standard Chartered (conventional) requires 6 months bank statement for salaried persons and 1 year bank statement for businessmen.

11-Copy of NIC and passport size photographs:
Diminishing Musharaka house financing.

Islamic banks require copy of NIC and passport size photographs.

Conventional house financing.

All traditional banks require copy of NIC and passport size photo graphs.

12-Business and job proof:

All banks both Islamic and conventional require evidence of business and job.

Table 2 summarizes similarities and differences in the two types of house financing contracts.

Table-2
Similarities and Differences in provisions of Contracts of Diminishing Musharaka house financing and Conventional house financing in Karachi 2006.

No	Contracts	Differences Yes/No
1	Commencement of Agreement	Yes (Partial)
2	Termination of Contracts	No
3	Risk of Loss	No
4	Ownership Contract	Yes
5	Contract to transfer of sole ownership	No
6	Expense consequent to ownership	No
7	Security	No
8	Liability of bank/client	No
9	Rights of bank / client	No
10	Penalty on late payment	No

Islamic banks participate in “profit” not in loss as do conventional banks. Standard Chartered (Islamic Bank), Meezan, Albaraka Islamic banks do not participate in losses they participate in profit as a “Shirkat-ul-Milk”.

There is no difference in termination of contracts the Islamic bank can terminate the contract without consent of its client if the client is not able to pay fixed “profit” rate and is not able to buy the bank’s share, on time. This is the same as in the conventional contract of termination.

Islamic banks charge penalty if the client does not pay scheduled amounts within 45 days. This is again similar to conventional contract provision.

In Diminishing Musharaka, all the expenses are paid by the client in consequent to transfer of ownership,. This is also the case with conventional house financing contracts.

No difference has been found in the rights and obligations of bank and client. In Diminishing Musharaka house financing the client and the bank has no right to sell their share to a third party. This is also similar to conventional contracts. Liabilities of clients and banks are similar in both types of financing.

Table 3 summarizes similarities and differences in terms and conditions of Diminishing Musharaka and conventional house financing contracts.

Table-3
Similarities and Differences in Terms and Conditions of Diminishing Musharaka and Conventional House Financing Contracts.

S.No	Terms and Conditions of Contracts	Difference Yes/No
1	Fixed “Profit” Interest Rate (salaried)	No
2	Fixed “Profit” Interest Rate (Businessman)	No
3	Age (salaried)	No
4	Age (Businessman)	No
5	Income (min)	No
6	Tenure	No
7	Amount min/max	No
8	Debt equity ratio	No
9	Insurance	No
10	Processing fees.	No
11	Mortgage Deed	Yes (Partial)
12	Bank statement (salaried)	No
13	Bank statement (Businessman)	No
14	Copy of NIC, Passport size Photo graphs.	No
15	Business Proof	No

Terms and conditions of contracts are identified in Diminishing Musharaka house financing and conventional house financing contracts. Islamic banks charge fixed rate of “profit” for Diminishing Musharaka house financing as do conventional banks for conventional house financing. Fixed rates are prohibited in Islam: however Standard Chartered (Islamic bank) charges a fixed “profit” rate of 14% to

15% for salaried persons and businessmen, Meezan Bank charges a fixed “profit” rate of 15% for salaried persons and 17% for businessmen, and Albaraka charges 12% for salaried persons and businessmen.

These rates are not only fixed but are also significantly higher than the interest rate on house financing charged by the conventional banks.

There are no differences in other terms and conditions of contracts. Both Islamic and conventional banks require age limit 25 to 60 years, minimum income Rs. 20000, debt equity ratio of at least 60:40. Conventional insurance is mandatory in both. House financing processing fee is similar in both Islamic and conventional banks, and both require business and job proof. Both offer house financing for tenure 1 to 15 years. All the documentation, terms and conditions are similar for Diminishing Musharaka house financing and conventional house financing in Karachi in 2006.

Assessment

Islamic banks do not follow Islamic principles. They misguide consumers through changing names of contracts, but in fact there is no difference between Diminishing Musharaka house financing and conventional house financing in Pakistan. The main objective of Islamic banks should be to prevent Riba transactions and concentration of credit but Islamic banks in Pakistan have failed to achieve these objectives. Islamic banks just follow conventional banks. Islamic banks charge fixed rate of “profit” as conventional banks charge fixed rate of interest. In Islam fixed rates are prohibited. Islamic banks charge fixed “profit” rate on their part of the finance. Islamic house financing is very expensive compared to conventional house financing. It is mainstream capitalist financing and has nothing to do with Islam.