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TRANSFER OF OWNERSHIP IN ISLAMIC BANKING – AS IN MURABAHA AND DIMINISHING MUSHARAKAH TYPES OF CONTRACT

ABSTRACT

PRZENIESIENIE WŁASNOŚCI W BANKOWOŚCI ISLAMSKIEJ NA PRZYKŁADZIE INSTYTUCJI MURABAHY I ZMNIEJSZAJĄCEJ SIĘ MUSZARAKI

Celem niniejszej publikacji jest analiza przeniesienia własności zgodnie z zasadami prawa islamskiego na przykładzie instytucji bankowości islamskiej – Murabaha i Zmniejszającej się Muszaraki. Autorka zdecydowała się na analizę sposobu oraz momentu przejścia własności w ww. umowach. Aby ułatwić czytelnikowi zrozumienie zagadnienia, autorka zdecydowała się przyjrzeć kwestii przeniesienia własności w prawie islamskim na przykładzie nieruchomości; biorąc pod uwagę popularność Murabaha i Zmniejszającej się Muszaraki w finansowaniu zakupu nieruchomości. Autorka przyjrzała się różnym zastosowaniom Murabaha i Zmniejszającej się Muszaraki w finansowaniu zakupu nieruchomości i starała się zbadać czy te transakcje są zawsze zgodne z prawem islamskim. Ponadto, autorka dokonała porównań ofert finansowania zakupu nieruchomości opartych na instytucjach Murabaha i Zmniejszającej się Muszaraki proponowanych przez banki islamskie.

KEYWORDS: ownership, Murabaha, Diminishing Musharaka, transfer, Islamic banking, bai', shirka, property

SŁOWA KLUCZOWE: własność, Murabaha, Zmniejszająca się Muszaraka, przeniesienie, bankowość islamska, bai', shirka, majątek

The article is devoted to the legal aspects of ownership and its transfer in Islamic banking. The author has chosen two types of contract – Muarabah (the so-called sale at the spot) and Diminishing Musharakah – to describe how the ownership is transferred in compliance with sharia. The choice was made based on the house financing schemes that Islamic banks offer to their clients. Since in house financing scheme the subject of the contract is ultimately the transfer of ownership of the real estate, it would be of interest for a reader to learn how the ownership of the real estate is transferred in Islamic banking. The other interesting issue that the author wishes to explore is that Murabah and Diminishing Musharakah are two different contracts stemming from a separate root.

The issue of ownership

In Islam the ownership *per se* falls into three categories:

- Public property/common goods
- State property
- Private property

However, one must be aware that as Allah created all the things including the sky, water, animals, etc. These are generally his property that men can use and benefit from. One has to remember that while analysing the question of property in Islam. Likewise, some scholars¹ provide the understanding of wealth similar to the one of property. Wealth is therefore also considered to be created by Allah and hence is his property. Whatever a man gains is done thanks to Allah.

As we read in the Quʾran: “He it is who created for you all that is on Earth.”² As wealth here would be a wider term than property one can say that property derives from wealth and from Allah. What is more, Islamic law does not distinguish the theory of property law³. The property law in practice is based on the Quʾran as a primary source of sharia, legal opinions (*fatwas*), jurisprudence, contracts and likewise.

1 Muhammad Imran Ashraf Usmani, *Meezanbank's guide to Islamic banking*, Darul Ishaat, Karachi, Pakistan 2002, p. 17.

2 *The Koran*, translated by J.M. Rodwell, Phoenix 1994, sura 2; 20: 7.

3 Richard A. Debs *Islamic law and civil code – the law of property in Egypt*, Columbia University Press 2010, p. 30.

As mentioned above, in Islam there are three categories of property.

Public property/common good covers the pieces of universe that is created by Allah and belongs to all the mankind. Hence the access to these areas cannot be lawfully limited. These include: sky, oceans, rivers etc.

The state property refers to the things that are also created by Allah but are used for the benefit of the people (e.g. mines). This type of property includes man-made things like buildings, roads and other public facilities that generally belong to the state but serve common interest.

Private property can be defined as a right of a man to possess a thing, enjoy it and derive benefits from it with the exclusion of other persons⁴. However, one must remember that in Islam private property is not absolute and is (in western understanding) limited. As we previously stated all property belongs to Allah. And therefore in theory private property can be compared to the institution of perpetual usufruct where the usufractor enjoys the possession of the thing, can derive benefits from the thing but is limited in time and is not the owner of the things. Islam does not prohibit or criticize the notion of private property as such, but rather puts emphasis on the religious aspect of it. The private property shall be “used” in compliance with sharia. And hence, transfer of the property must observe the rules of sharia as well.

It implies refraining from unlawful practises (like e.g. *riba*⁵, derivatives contracts) and trading in *haram* goods (e.g. pork, weapons). The contract the subject of which is any of the forbidden things will be considered void by the virtue of law and therefore invalid. Similarly, where the *haram* practice is involved it will be also considered invalid. Apart from the above-mentioned restrictions, the transfer of ownership should observe the general rules of contracts of Islam. That means that both

4 Some scholars when writing about different categories of property in Islam also mention waqf (Aini Aryani, *Ownership in Islamic Perspective*, <http://ainiaryani.blogspot.com/2008/06/ownership-in-islamic-perspective.html> [accessed: 29 October 2016]; Richard A. Debs, *Islamic law...*, *op. cit.*, p. 31; Cem Nizamoglu, *The Institution of Waqf as a Solution to the Economic Crisis*, <http://www.muslimheritage.com/article/institution-waqf-solution-economic-crisis> [accessed: 29 October 2016]). The waqf, for the aim of this article, can be defined as being an owner of a possessor of thing and preserving it for the public benefit/charitable purpose. It includes depriving oneself from the private property to transfer it to others (“Awqaf is a voluntary act of charity”, as stated here: *What is Awqaf?*, “Awqaf {Endowments}” 2015, Vol. XCIII, No. 311, <https://prezi.com/sulo9cg67lta/awqaf-endowments/> [accessed: 29 October 2016]).

5 Riba – prohibited interest.

parties to a contract should be sane at the time of entering into a contract, both should be mature (adult, but a day-to-day sale when a minor buys something from a shop is allowed), capable of entering into contracts and understand the purpose of the transaction. The contract should be unconditional. The subject of contract (that includes the transfer of ownership) should exist at the time of entering into a contract, should be of value and should be specified and usable. It cannot be *haram* (e.g. pork) and can be owned (that excludes common goods like rivers etc.).

One must emphasize here that in case of transfer of ownership, the party that transfers it must be the owner of it, and must possess the thing so that the possession⁶ can be transferred accordingly along with the ownership.

How the ownership is transferred – bai' sale

As we will look into one of the most popular contracts in Islamic banking – Murabaha (also called Bai Murabaha), we will look at the contract of sale (bai') that Murabaha derives from.

In bai' the purpose of a contract is a sale of a thing and thus transfer of ownership and possession. *Essentialia negotii* of a valid bai' include the following elements:

- Subject matter (Mube'e)
- Price (Thaman)
- Delivery (Qabza)

Some scholars⁷ claim that the contract *per se* (Aqd) is required for a valid sale. But in the author's opinion, the sale is in itself a contract, so should not be regarded as *the essentialia negotii* of a sale contract. Unless, as a contract we understand the basic principles of contracting in compliance with sharia.

As mentioned above, the subject of sale cannot be prohibited by sharia. Must be in the ownership and possession of a seller. Must be usable, of value. Can be freely transferred (the sale of it is not prohibited and it

⁶ Muhammad Imran Ashraf Usmani (*Meezanbank's guide...*, *op. cit.*, p. 79) mentions the institution of constructive possession, where the owner does not literally possess the thing but has the legal titles to it, has control over it and bears all the risk connected therewith.

⁷ Muhammad Imran Ashraf Usmani, *Meezanbank's guide...*, *op. cit.*, p. 73.

can be owned). The subject matter must exist at the time of contracting and should be clearly specified in a contract (whether written or oral).

Likewise, the price has to be specified and certain (cannot be changed throughout a sale).

The seller must possess the subject matter of sale and must deliver the thing to the buyer. However, one should not take the above mentioned literally. In the case of real estate, such delivery would not be physically possible (one cannot take a building, pack it in its pocket and bring it to the buyer). In such a case, delivery would imply transferring all the documents and things (like keys, codes etc.) required to effectively transfer the possession of the real estate. We must remember that in European law generally a contract of sale is a so-called consensual contract. It means that physical delivery of the subject matter is not required for a sale contract to be valid. A representation of will of the parties is what matters along with observing the *essentialia negotii* of the sale (that also include the subject matter and the price).

The result of the bai' is the transfer of the ownership of the subject matter from the seller to the buyer, the delivery of possession to the buyer and payment of the price (on the spot) by the buyer to the seller.

Muarabaha

As mentioned above, Murabaha is a type of sale contract (bai'). In Murabaha, the seller sells the thing at a price to the buyer and the buyer know the profits the seller gets from the sale⁸. This means that the seller discloses the amount of profit for him that is included in the price of the thing⁹. Murabaha to be valid must observe the main principles of bai' contract (see: above). It is not permitted in Murabaha to apply rollovers, buy backs or sale without transfer of possession.

In Murabaha¹⁰ as practised in Islamic banking, the prospective buyer addresses an Islamic finance institution indicating that he wishes to buy

⁸ Maulana Ejaz Ahmad Samadani, *Islamic banking & murabaha*, Darul Ishaat, Karachi, Pakistan 2008, p. 14 defines murabaha as „a sale of a thing on cost plus profit basis”.

⁹ Contrary to the different type of a sale contract – Bai' Musawamah, where the seller does not disclose the profit to the buyer.”.

¹⁰ A reversed murabaha known as Tawarruq is also used as a way of financing the purchase of goods – for more see: B. Paxford, *Tawarruq – on the road to liquidity*, “Business Islamica” 2012, No. 03.

a certain thing (e.g. flat). The institution buys a flat (in its name and on its own behalf or appoints a client as its agent where he buys the thing on behalf of the institution) and then sells it to the client for cost of the purchase plus the institution's profit. The elements of the price are disclosed to the client.

At present, Murabaha transaction consists of several contracts that include master Murabaha contract (that works like a frame agreement), agency contract (where the client as an agent on behalf of the bank – *wakalah*), sale contract (where the thing is sold to the client and the price and modes of payment determined). Generally, Murabaha implies a spot payment, but in the case of a sale of real estate and likewise, the payment will usually be deferred.

When the client acting as an agent of the Islamic finance institution purchases the thing, it should become the ownership of the institution (not of the agent) but can remain in possession of the client (but in constructive possession of the institution – see: footnote no. 5). Upon taking the possession of the thing, the client addresses the institution to purchase the thing from it. In this period of time (between taking the possession of the thing and entering into the sale Murabaha contract) the client cannot resell the thing or consume it¹¹.

When the Murabaha contract is entered into the institution sells the thing to the client and the client becomes the owner of the thing and bears all risks connected therewith. The price he owes to the institution is treated similarly to a loan¹². What is interesting is that the purchase and spot on resale of the thing by the institution is not recorded in its books¹³.

In practice, the title to the thing often goes straight from the first owner of the thing to the client (omitting the institution). It is done in order to avoid paying double taxes connected with the sale of things and to avoid the risks as implied in certain banking acts. And it renders the transaction not fully compliant with a proper Murabaha's purpose.

The client is obligated to pay back the price (either on the spot or on deferred terms in instalments). As mentioned above the price can be treated similar to a loan (*quard*). The institution to secure the payment of the price will usually ask the client to provide the hypothecation/mortgage

11 Maulana Ejaz Ahmad Samadani, *Islamic banking...*, *op. cit.*, p. 37.

12 *Ibid.*, p. 42.

13 Hussain Kureshi, Mohsin Hayat, *Contracts and deals in Islamic finance*, Wiley, 2015.

(in case of the real estate), pledge or likewise. The default in payment does not usually result in penalty. As the price is settled and certain (and cannot be changed throughout the transaction), the institution cannot charge the client any additional payments (it would result in the change of the price and would not be permissible). The client that is in delay should be obligated to pay the fixed amount to the special charity fund created for this purpose by the institution. The money paid to the fund is not property of the institution and can only be used for charitable purposes in compliance with sharia. Likewise, the institution is not obligated to grant a discount to the client when he pays the price before due time. Such discount would also influence the price settled in the Murabaha contract. However, the institution can take a decision and grant such discount to the client upon its own discretion and such discount should be separate from Murabaha contract.

The transfer of ownership through shirka

Contrary to Murabaha, shirka is not a sale contract, but a contract similar to articles of association. The purpose of shirka is to work together in a company/venture to obtain a common goal. All parties thereto are generally obligated to provide contributions to shirka's capital. The capital becomes the common property of the shirka and the parties to the contract (called the partners) are authorised to sell and to dispose of the property of shirka. Usually, all partners are authorised to represent shirka and take legal actions on behalf of the venture. However, it is possible that some partners cede their rights to represent the shirka and that only selected partners will represent the shirka and will in fact act as its managers.

There are a few types of shirka like e.g. shirkat – ul – milk, shirkat – ul – Ain, or shirkat – ul – aqd. The main difference between these types of contract is related to the title of ownership of the common property and the question whether the parties voluntarily enter into a contract (by entering into a contract or by becoming the heirs of the deceased owner of the estate).

The most common shirkas are musharakah and mudarabah. For the purpose hereof, we will describe briefly the Musharakah. Musharakah is also known as shirka – ul – Amwal. The parties known as partners enter into a mutual contract where they create a partnership. The partners

contribute their property to the capital of the partnership. Their aim is to obtain profit from the work of the partnership. The goods purchased by the partnership become the ownership of the shirka and therefore its partners. The partners all bear the risks connected with the venture. They share the profit as well as loss. The loss is divided in accordance with the profit ratio¹⁴. Therefore, any stipulation in musharakah's contract that a partner can be released from taking part in losses should be deemed void. Moreover, the profit ratio should be connected with the investment ratio¹⁵.

In Musharakah, a partner can represent and can manage the partnership. It is also possible to exclude (upon the partner's consent) some partners from the representation and management of the partnership. Nevertheless, such decision may result in a diminished profit for such a partner. As he/she does not bear the risk, he/she shall not participate in the profit more than the ratio of its investment in the partnership. One must remember that Islam rewards those who take the risk. Therefore, these partners who represent and manage the partnership should obtain higher ratio of the profit.

The Musharakah contract cannot stipulate the fixed amount of the profits for the partners; it should be done in percentage in compliance with the investment ratio.

The capital of Musharakah is divided into shares. Hence, if a partner wishes to leave the venture, it should sell its shares. The shares should be sold to the remaining partners. The price for the shares sold should be agreed among the partners.

Diminishing Musharakah

This kind of Musharakah is based on a share in joint property. It means that partners do not enter into a Musharakah contract to work as a standard partnership and trade goods. The purpose of Diminishing Musharakah is joint ownership of a thing by parties, where one of the parties gradually sells its shares to the other so that in the end the other party becomes a sole owner of the thing and the sole shareholder of the partnership.

¹⁴ Muhammad Imran Ashraf Usmani, *Meezanbank's guide...*, *op. cit.*, p. 94).

¹⁵ *Musharakah*, <https://cief.wordpress.com/2006/03/12/musharakah> [accessed: 29 October 2016].

Murabaha and Diminishing Musharakah in house financing scheme

He, who sold the house and for the amount received did not buy another one shall not receive God's blessing¹⁶.

Both Murabaha and Musharakah are used in purchasing the house with the help of Islamic banks. For the purpose of this article, the author looked into the house financing schemes offered by various Islamic banks. For instance, Britain – based Al Rayan Bank offers for its client to purchase real estate through Diminishing Musharakah and Ijarah (leasing)¹⁷. The client pays monthly instalments (that comprises acquisition payment and rental payment). When the client pays all acquisition payments, the ownership of real estate is transferred to him. Dubai Islamic bank¹⁸ offers purchase of real estate with the Murabaha mode¹⁹. For the corporate client the bank also offers Murabaha mode²⁰ for purchase of land and buildings, client can also use Diminishing Musharakah mode to finance the purchase of the real estate²¹. In such way, a corporate client and a bank form a partnership. Partnership purchases the real estate and becomes its owner. Then the client gradually purchases the shares in the partnership from the bank in order to become the sole owner of the property. One must bear in mind though, that finally the partnership with the client as a sole shareholder of it will be the owner of the property not the client as such.

¹⁶ Mahomet, *O małżeństwie, kupcach i dobrych wychowaniu. Wybór hadisów*, transl. by Jolanta Kozłowska, Wydawnictwo Akademickie Dialog, Warszawa 1999, p. 63, translated into English by the author.

¹⁷ *Home Purchase Plan*, <http://www.alrayanbank.co.uk/home-finance/home-purchase-plan/> [accessed: 29 October 2016].

¹⁸ *Al Islami Home Finance For UAE Nationals*, <http://www.dib.ae/personal-banking/finance/al-islami-home-finance/al-islami-home-finance-for-uae-nationals/overview> [accessed: 29 October 2016].

¹⁹ Similarly, the Saudi Arabia – based Riyad bank provides the house finance through murabaha.

²⁰ *Murabaha on Buildings*, <http://www.dib.ae/corporate-banking/real-estate/murabaha-on-buildings/overview> [accessed: 29 October 2016].

²¹ *Diminishing Musharika*, <http://www.dib.ae/corporate-banking/real-estate/diminishing-musharika/overview> [accessed: 29 October 2016].

Summary

The key to understanding legal issues in Islamic banking is to be aware of the religion entwined with business and observing the principles of Islam. As mentioned at the beginning of article, the theory of property law in Islam has not been codified or defined as such. As the main source of all property is divine the most crucial and primary sources of law are to be found in the Qu'ran. One must remember that property here cannot and should not be construed in the western understanding of it. Even private property is not absolute and limited. However, it is permitted and practiced to transfer the ownership as in other legal systems. The main aspects of such transactions are that they observe the sharia. Hence, the limitations to the transfer. As stipulated herein for transfer of the property the instruments of Murabaha and Diminishing Musharakah are applied. One of them transfers the property on the grounds of sale, the other on the grounds of a partnership. In both of them the final goal is the transfer of the ownership of the property to a client/buyer. The difference between the Islamic banking instruments and the western ones is, apart from the sharia issue, a level of complication of the transaction. As mentioned herein, both in Murabaha and Diminishing Musharakah several agreements must be entered into. That can hinder the popularity of these instruments as well as unfriendly tax systems (that for instance, do not provide the release from double taxation of the double sale transactions). However, one must bear in mind that that the purpose of these transaction is to purchase a commodity in compliance with sharia and for the general benefit for the society.

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