Quarterly Research Journal "Al-Qudwah", Volume 03, Issue 01, Jan-Mar 2025

AL-QUDWAH
ISSN(P): 2959-2062 / ISSN(E): 2959-2054
https://al-qudwah.com

Substance Over Form in Islamic Home Financing: Jurisprudential Foundations and Operational Challenges of Diminishing Musharakah in Pakistan (A Case Study of Meezan Bank's Easy Home)

ABSTRACT

Diminishing Musharakah (DM) has become an important mode of Islamic home financing. It is based on joint ownership of an asset, the leasing of the financier's share to the customer, and the gradual transfer of ownership units to the customer. Although this arrangement offers an alternative to conventional interest-based financing, its Shariah compliance depends on the genuine implementation of ownership, lease, sale, and risk-sharing requirements. This study examines the jurisprudential foundations, regulatory requirements, and operational challenges of Diminishing Musharakah in Pakistan's Islamic banking sector. It also analyses Meezan Bank's Easy Home product as an institutional case study, focusing on its published financing structure, rental mechanism, unit-purchase arrangements, early settlement provisions, and Takaful coverage. The study adopts a qualitative doctrinal and documentary approach, drawing upon classical Islamic jurisprudence, State Bank of Pakistan (SBP) regulations, AAOIFI standards, and publicly available product information. It finds that the Shariah validity of Diminishing Musharakah cannot be established merely through the use of Islamic terminology or institutional approval. Rather, it requires genuine ownership, valid rental entitlement, actual transfer of ownership units, appropriate allocation of risks and expenses, and substantive independence of the constituent contracts. The study recommends stronger transaction-level Shariah audits, transparent contractual documentation, and improved customer disclosure.

Keywords: *Diminishing Musharakah, Islamic Banking, Shirkat-ul-Milk, Ijarah, Shariah Compliance, Home Financing.*

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Date of Submission: 30-12-2024
Acceptance: 29-01-2025
Publishing: 09-02-2025

Web: https://al-qudwah.com/
OJS: https://al-qudwah.com/index.php/aqrj/user/register
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1. Introduction

Islamic banking seeks to provide financial services in accordance with the principles of Shariah, particularly the prohibition of Riba (interest), unjust enrichment, and transactions involving excessive uncertainty. The Qur'an clearly distinguishes permissible trade from prohibited Riba [1]. In this context, Islamic banks have developed various financing arrangements based on trade, leasing, and partnership.

Diminishing Musharakah has emerged as a widely used mechanism for home financing. Under this arrangement, the bank and customer jointly purchase a property. The customer gradually purchases the bank's ownership units while paying rent for the bank's remaining share. Consequently, the customer's ownership increases over time, while the bank's ownership and rental entitlement decrease.

Despite its growing use, several Shariah and operational questions remain significant. These include the authenticity of joint ownership, the validity of rental arrangements, the transfer of ownership units, the allocation of maintenance and ownership-related risks, the use of conventional benchmarks such as KIBOR, and the independence of the constituent contracts.

This study examines these issues through the principles of Islamic commercial law and Pakistan's regulatory framework. It further considers Meezan Bank's Easy Home product to assess how the published structure addresses some of these requirements.

2. Jurisprudential Foundations of Diminishing Musharakah

Diminishing Musharakah is generally structured through three related arrangements: joint ownership, leasing, and the gradual sale of ownership units.

2.1 Joint Ownership (Shirkat-ul-Milk)

"Joint ownership (Sharikah al-Milk) is the state of a thing being shared among more than one person; that is, belonging exclusively to them through one of the causes of acquiring ownership, such as purchase, acceptance of a gift, acceptance of a bequest (will), or inheritance." [2]

The first stage involves the joint acquisition of a property by the bank and the customer. Both parties contribute capital according to their agreed ownership shares. This arrangement is commonly described as Shirkat-ul-Milk, meaning joint ownership of a specific asset.

It is important to distinguish Shirkat-ul-Milk from Shirkat-ul-Aqd. The former concerns joint ownership of property, whereas the latter involves a contractual partnership in business or investment. In home financing through Diminishing Musharakah, the relevant relationship is generally Shirkat-ul-Milk.

The bank must genuinely acquire its agreed share in the property. Ownership should not be merely nominal or a legal formality designed to disguise an interest-based loan.

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[1] Al-Baqarah 2:275

[2] Majallah al-Ahkam al-Adliyyah (The Ottoman Civil Code), Book 10 (Kitab al-Sharikat), Section 3, Article 1331.

2.2 Leasing of the Bank's Share (Ijarah)

"Linguistically, Ijarah means 'wage/rent,' and it is also used in the sense of 'letting out on hire.' In the terminology of the jurists, it means the sale of a known usufruct (benefit) in exchange for a known consideration (payment)." [3]

After joint ownership is established, the customer may use the property by paying rent for the bank's share. Since the customer already owns a portion of the property, rent is payable only for the portion owned by the bank.

As the customer purchases additional units, the bank's ownership decreases. Consequently, the rental amount should also be adjusted according to the remaining share of the bank.

The validity of this arrangement requires that the leased share be identifiable and that the rental terms be clearly determined. Furthermore, ownership-related risks must remain with the owner in accordance with the principles of Ijarah.

2.3 Gradual Purchase of Ownership Units

The third component involves the gradual purchase of the bank's ownership units by the customer. Each transfer should constitute a genuine sale, with the relevant ownership share transferred in accordance with the agreed procedure.

The customer's ownership increases with every completed purchase, while the bank's ownership decreases. A mere promise to purchase units does not itself transfer ownership. The sale and its legal consequences must be properly established.

2.4 Shariah Basis

The Qur'anic principles of fulfilling contractual obligations[4] and avoiding wrongful consumption of wealth[5] provide the broader ethical and legal foundation for Islamic financial transactions.

Classical jurists have discussed partnership, joint ownership, leasing, and sale in detail. These principles provide the basis for structuring contemporary Diminishing Musharakah, provided that the individual contracts and their practical implementation comply with Shariah.

3. Shariah and Regulatory Requirements

In Pakistan, the State Bank of Pakistan has issued a specific Shariah Standard on Sharikat-ul-Milk and Diminishing Musharakah through IBD Circular No. 02 of 2013. The standard provides guidance for Islamic financial institutions regarding the formation and operation of such arrangements.

The principal requirements may be summarised as follows:

First, genuine ownership: The bank must acquire and hold its agreed share in the property. Its ownership should involve actual legal and financial consequences.

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[3] Al-Kasani, 'Ala' al-Din. Bada'i al-Sana'i fi Tartib al-Shara'i. Vol.3, p142

[4] Al-Ma'idah 5:1

[5] Al-Nisa' 4:29

Second, valid Ijarah: Rent may be charged only for the bank's remaining ownership share. The rental arrangement must identify the leased share and the applicable rental terms.

Third, actual transfer of units: The customer must purchase the bank's ownership units through valid sale transactions. Ownership should not be treated as transferred merely because instalments have been paid.

Fourth, appropriate risk allocation: Ownership-related risks and liabilities must be allocated according to the actual ownership structure. A financier cannot claim the benefits of ownership while transferring every ownership-related liability to the customer.

Fifth, contractual independence: The partnership, lease, and sale arrangements must retain their respective legal characteristics. Their combination should not result in a prohibited conditional transaction or a device for guaranteeing a fixed return on a loan.

AAOIFI Shariah Standards, particularly Standard No. 9 on Ijarah and Ijarah Muntahia Bittamleek, Standard No. 12 on Sharika, and Standard No. 25 on Combination of Contracts, also provide relevant guidance. Their application should be considered alongside the specific SBP requirements governing Diminishing Musharakah. [6]

4. Major Operational and Shariah Compliance Challenges

Although the structure of Diminishing Musharakah is theoretically recognised in Islamic commercial law, its practical implementation raises several important concerns.

4.1 Ownership and Documentation

The first major challenge concerns the establishment of genuine joint ownership. If the bank does not acquire its share in the property or the ownership documents do not reflect the actual arrangement, the fundamental basis of Diminishing Musharakah may be weakened.

Proper documentation should identify the ownership proportions, acquisition details, and legal responsibilities of both parties.

4.2 Rental Calculation

Rent must be charged against the bank's remaining ownership share. As the customer purchases units, the bank's share decreases and the rent should be recalculated accordingly.

A rental formula should be transparent and understandable to the customer. Any benchmark-based adjustment must operate within a valid Ijarah arrangement and must not transform rent into interest on an outstanding loan.

4.3 Use of KIBOR as a Benchmark

Some Islamic banks use KIBOR as a reference for determining or revising rental rates. The use of a conventional benchmark does not, by itself, make a transaction impermissible. The decisive issue is the underlying contractual structure.

[6] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Shari'ah Standards, particularly Standards Nos. 9, 12 and 25. Manama: AAOIFI.

If the bank genuinely owns the property, leases its share, and charges rent for an identifiable usufruct, a benchmark may be used as a pricing reference subject to Shariah requirements. However, the rental formula must be disclosed, and the arrangement must not guarantee a return on a cash loan irrespective of ownership and leasing obligations.

4.4 Maintenance and Ownership-Related Expenses

Another important issue is the allocation of maintenance and other expenses. Islamic jurisprudence distinguishes between ordinary expenses arising from the customer's use of the property and expenses or liabilities associated with ownership.

The customer may be responsible for routine operational and usage-related expenses under the lease. However, ownership-related liabilities cannot automatically be transferred entirely to the customer where the bank remains a co-owner. The contractual arrangements should reflect the actual nature of each expense and the parties' respective responsibilities.

4.5 Independence of Contracts

Diminishing Musharakah combines partnership, leasing, and sale arrangements. Their combination is acceptable only when the legal requirements of each contract are maintained.

The mere preparation of separate documents does not necessarily establish contractual independence. The actual terms, sequence, and legal effects of the agreements must be examined to ensure that one contract does not invalidate or improperly condition another.

4.6 Early Settlement and Termination

Early settlement provisions require particular attention. The parties should clearly understand how the bank's remaining ownership units will be valued and transferred when the customer wishes to complete the arrangement before its scheduled maturity.

The agreed price and method of calculation must be transparent and consistent with the applicable Shariah requirements. Any additional amount should be examined according to its contractual basis and actual function.

5. Case Study: Meezan Bank's Easy Home

Meezan Bank offers Easy Home as an Islamic home financing product based on Diminishing Musharakah. Its publicly available product information describes a structure in which the bank and customer jointly own a property, the customer pays rent for the bank's share, and the customer gradually purchases the bank's ownership units. [7]

The following analysis is based on the bank's published product information. It should not be understood as a complete review of its financing agreements or individual transactions.

5.1 Financing Structure

The published Easy Home structure identifies Shirkat-ul-Milk as its underlying arrangement. The bank and customer jointly acquire the property, and the customer gradually purchases the

[7] State Bank of Pakistan. (2013). IBD Circular No. 02 of 2013: Shariah Standard on Sharikat-ul-Milk and Diminishing Musharakah. Karachi: State Bank of Pakistan.

bank's share.This structure is consistent in principle with the general framework of Diminishing Musharakah. However, its practical Shariah compliance depends on actual ownership, proper documentation, and the effective transfer of ownership units. [8]

5.2 UMI and Step-up Models

Meezan Bank publishes different payment arrangements, including the UMI and Step-up models. Under the UMI arrangement, the unit price remains constant while the rental amount is adjusted according to the bank's remaining ownership units.

Under the Step-up arrangement, the published description provides for the purchase of one unit per month during the first half of the financing period and two units per month during the second half.

These arrangements should be assessed in terms of their contractual clarity and actual implementation. In particular, the customer should be able to understand how each payment affects ownership and rental obligations. [9]

5.3 KIBOR-Based Pricing

The bank's published product information refers to KIBOR-based pricing and identifies different pricing terms for salaried and business customers, including a floor and cap.

The use of KIBOR as a reference rate is not automatically contrary to Shariah. Nevertheless, the rental agreement must remain connected with the bank's actual ownership and the usufruct made available to the customer. The applicable pricing formula, revision mechanism, and financial consequences should be clearly disclosed in the relevant agreement and Product Key Fact Statement.

The published webpage may not reflect every current contractual term. Therefore, the latest product documents should be consulted before drawing a final conclusion about the present pricing arrangements.

5.4 Early Purchase of Units

Meezan Bank's published information states that where the property appreciates, units may be purchased at 3% above their face value, while in cases where the property value remains unchanged or decreases, the units may be purchased at face value.

This provision requires careful examination. The Shariah assessment depends on the contractual basis of the additional amount, the method of valuation, and the manner in which the sale is concluded. It should not be declared impermissible merely because an additional amount is mentioned; equally, it should not be accepted without examining whether the agreed arrangement constitutes a valid sale price or an unjustified additional charge. [10]

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[8] Ibn Qudamah, 'Abd Allah ibn Ahmad. Al-Mughni, Vol. 5, p165

[9] Eldersevi, F., & Zakaria, M. S. (2023). Diminishing participation between AAOIFI standards and Shariah standards of the Central Bank of Malaysia: Its foundation and exegesis. International Journal of Al-Turath in Islamic Wealth and Finance, 4(1), 67–91. https://doi.org/10.31436/ijaiwf.v4i1.770

[10] Nouman, M., Ullah, K., & Jan, S. (2019). Variants of participatory financing for risk assessment and mitigation in Islamic banking. Business & Economic Review, 11(4), 1–34. https://doi.org/10.22547/BER/11.4.1

5.5 Takaful Arrangements

The product information refers to Life Takaful. The nature of the coverage, its contribution, and the responsibilities of the parties should be clearly explained to customers. Life Takaful should also be distinguished from coverage relating to damage or loss of the jointly owned property.

The available public information does not, by itself, establish all the details of property-related Takaful arrangements. These should be verified through the applicable product documents.

5.6 Overall Assessment of the Case Study

The published Easy Home structure reflects the principal components of Diminishing Musharakah: joint ownership, rental of the bank's share, and gradual purchase of units. Nevertheless, the product webpage alone cannot establish whether every transaction fulfils the relevant Shariah requirements.

A conclusive assessment would require examination of the actual partnership agreement, Ijarah agreement, unit-purchase documents, property ownership records, Takaful arrangements, and relevant Shariah audit findings.

6. Findings and Recommendations

6.1 Major Findings

The study identifies the following findings:

1. Diminishing Musharakah is a recognised Islamic home financing structure when its constituent contracts fulfil their respective Shariah requirements.

2. Genuine ownership is the foundation of the arrangement; nominal ownership cannot justify rental income.

3. Rent must correspond to the bank's remaining ownership share and be adjusted as ownership units are transferred.

4. The use of KIBOR as a pricing benchmark does not automatically invalidate the arrangement, provided that the underlying ownership and Ijarah are genuine.

5. Ownership-related risks and expenses must be allocated consistently with the parties' actual ownership interests.

6. Meezan Bank's published Easy Home information reflects the general structure of Diminishing Musharakah, but public product information is insufficient to establish transaction-level compliance.

6.2 Recommendations

In light of these findings, the following measures are recommended:

Strengthen ownership documentation: Islamic banks should maintain clear records establishing their actual ownership shares in financed properties.

Ensure transparent rental calculations: Rental formulas and periodic adjustments should be clearly disclosed to customers.

Maintain contractual independence: Partnership, leasing, and sale arrangements should retain their separate legal requirements and effects.

Allocate risks appropriately: Ownership-related liabilities should be borne in accordance with the actual ownership structure.

Clarify early settlement provisions: Methods of valuing and purchasing remaining units should be explained in the contractual documents.

Improve Takaful disclosure: Customers should be informed about the nature, cost, and scope of relevant Takaful arrangements.

Strengthen Shariah audits: Shariah supervision should examine actual transactions, ownership records, rental calculations, and unit transfers rather than relying exclusively on standard product documents.

Promote customer awareness: Banks should provide accessible explanations of ownership shares, rental obligations, unit purchases, and early settlement procedures.

7. Conclusion

Diminishing Musharakah provides an important alternative to conventional interest-based home financing. Its legitimacy is based on genuine joint ownership, valid leasing, and the gradual transfer of ownership through actual sale transactions. However, the use of Islamic terminology or approval of a product structure is not sufficient to establish its practical Shariah compliance.

The analysis demonstrates that the major challenges concern ownership documentation, rental calculation, risk allocation, contractual independence, and early settlement. The case study of Meezan Bank's Easy Home illustrates how these issues arise within a contemporary Islamic banking product. Although its published structure reflects the principal components of Diminishing Musharakah, a final judgment about actual compliance requires examination of the underlying contractual and transactional records.

The long-term credibility of Islamic home financing therefore depends on ensuring that its practical operations reflect the principles of Islamic commercial law. Stronger Shariah governance, transparent documentation, fair risk allocation, and effective transaction-level audits are essential for maintaining public confidence in Diminishing Musharakah.

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