Diminishing Musharakah: The Dilemma in Pakistan

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Shariah compliant Islamic banking was introduced in Pakistan in 2003. The State Bank of Pakistan (SBP), the regulatory authority for banks, introduced regulations which allow for conventional banks to open Islamic banking branches and for banks to commence purely Islamic banking operations in Pakistan. The documents used by the banks to support Islamic banking transactions are based on the directives of the SBP and on the advice of the Shariah board or Shariah advisor of each bank.

In this article we have chosen the Diminishing Musharakah for housing finance products to highlight the need to amend the civil laws of Pakistan to support Shariah compliant banking transactions. Diminishing Musharakah is being used by Islamic banks in Pakistan to extend housing finance to customers. It is increasingly popular amongst potential home owners who wish to use a Shariah compliant product.

SBP’s Islamic Banking bulletin in its January-March 2009 edition reports an increase of 4% in Diminishing Musharakah products which would include both asset and home finance. Diminishing Musharakah had a share of 32% in the Islamic financing market as of March 2009.

The essential features of a Diminishing Musharakah as transacted in Pakistan are:
1. Creating a joint ownership in the property (Shirkat-ul-milk).
2. Allowing the customer the use of joint Musharakah property on the condition that the customer pays a rent to the bank on the bank’s Musharakah share in the property.
3. The customer undertakes to purchase the Musharakah share of the bank, which are described as Musharakah units, according to a schedule of redemption.
4. The rental payable by the customer to the bank is adjusted according to the Diminishing share of the bank in the Musharakah property.

A basic legal issue involving the civil laws needs to be addressed in light of the Shariah principles governing Diminishing Musharakah. That concerns whether the transfer of property laws in Pakistan recognizes a beneficial ownership in immovable property.

According to the principles of Shariah, in a Diminishing Musharakah home finance, the customer is the legal owner of the property and the property is registered in the customer’s name. However, the bank is treated as a “beneficial owner” to the extent of the bank’s share in the financing.

However, the Transfer of Property Act 1882 does not expressly recognize “beneficial ownership”. A reader may well ask why the civil laws and in particular the Transfer of Property Act have any impact on a Shariah compliant product. The answer is that, whereas the product is based on Shariah principles, it still relies on certain civil laws to support particular segments of the transaction.

A transfer of the financed property in favor of a customer takes place under the Transfer of Property Act and whereas it would be fitting to record the interest of the bank as a beneficial owner in the registration records, this is not possible at present because, as stated earlier, the Act does not expressly recognize beneficial ownership and the established procedure records only legal ownership.

However, notwithstanding the fact that only legal ownership may be officially recorded, it is pertinent that the Act recognizes “benami ownership” and “ostensible ownership”. The expression “benami” is derived from the Urdu language and in law it denotes transactions not for the benefit of the persons taking part in the transactions but for the benefit of a person or persons not mentioned or named in the transaction. A “benamidar” is a person who acts for the actual owner in a transaction.

The concept of a benami transaction or one person being a benamidar of another is recognized under Section 5 of the Act. Ordinarily, when two or more persons agree to acquire land jointly, the land, though purchased in the name of one person, would belong to all of them if the person who acquires the property in his own name acting honestly intends to acquire it on behalf of all. In such a case he would be a benamidar, while the others would be benami owners.

If, on the other hand, the person who purchased the property in his own name with joint funds which were contributed on the understanding that the property was to be joint, was not acting honestly at the time when he actually made the purchase, he would not be benamidar for the others but would be a trustee for the others to the extent of their shares and a beneficial interest to the extent of the shares would belong to the others. There is thus a distinction between a benamidar and a person who holds in trust.

In India and Pakistan the typical examples of such transactions are if a husband purchased property in the name of his wife. Then, unless otherwise explained, the purchase is presumed to be a benami transaction by which the beneficial interest in the property is with the husband and the ostensible ownership is with the wife.

“Ostensible ownership” is another concept which is recognized by Section 41 of the Act. This section provides that where an ostensible owner, with the consent of the persons interested in the property, transfers the same for consideration, the transferee shall acquire a good title provided the transferee took reasonable care to ascertain that the transferor had the power to make the transfer and acted in good faith. The Transfer of Property Act, by recognizing benami transactions and ostensible ownership, provides the scope for introducing the concept of beneficial ownership. This may be incorporated into the law by providing for and recognizing beneficial ownership and thus recording the interest of the legal and the beneficial owners respectively in the registration records and the title documents to the property.

This would protect and secure the interest of the bank under a Diminishing Musharakah and do away with the requirement for the bank to obtain a mortgage on the property. It ought to be noted that a mortgage on a financed property is created pursuant to Section 58 of the Act and is based on the principles of English land law. The most common forms of mortgages in Pakistan is by deposit of title deeds and a registered mortgage. A mortgage creates a limited security interest in the property in favor of a bank and secures its right to recover its

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share in the Musharakah property if the customer defaults in any of his or her obligations. The creation of a mortgage as security appears to be inconsistent with the principle of joint ownership of a property as enshrined in a Diminishing Musharakah arrangement.

The requirement of a mortgage may be done away with if the legal and beneficial interest in the property in the names of the bank and the customer can be officially recorded. This may be supplemented with a power in favor of a bank to assert its rights if the customer defaults in any of his obligations. In order to reduce the costs of a transaction which involves transfer of title to a bank and a customer jointly, a bank’s Musharakah share should be exempted from property, stamp duty and registration taxes.

By highlighting these legal issues we wish to emphasize the need to amend the civil laws of Pakistan to give adequate support to Shariah compliant financial products used by the Islamic banks and Islamic banking branches of conventional banks and provide some options for possible amendments to laws which were framed for the Indian subcontinent by the British based on the concepts of English law.

It is time for Pakistan’s lawmakers to acknowledge the profound changes which have taken place in the banking and finance markets in the country following the introduction of Shariah compliant Islamic banking and amend the laws to provide a solid basis for present and future Islamic banking products.

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