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Islamic home financing and ownership transfer to the customer: Models compared

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Abstract

In my latest article on Islamic home financing models in the ISRA Journal June 2013, I had shown that the Zubair Diminishing Balance Model (ZDBM) is free of return compounding and the transfer of ownership to the customer perfectly matches the payments' rate; the two norms Islamic models must meet. It is satisfying to note that Nabil in the same issue of the journal takes up these issues in a comprehensive and tightly argued conceptual paper and convincingly vindicates my position on the compounding issue. However, he argues that the transfer of ownership in the ZDBM also does not meet the ideal even as it is closer to the norm than other constructs. The objective of this brief note is to clarify my position on this latter issue.

Key words: Shari'ah norms; home financing, ZDBM; MMP; Segmental murabahah

1. INTRODUCTION

The paper of Nabil (2013) has convincingly established that Islamic home financing models in current use involve compounding of return on capital – interest, rent or mark-up -if the Excel formula is used for the determination of a uniform periodic installment payment.² However, the paper argued that in the ZDBM too the ownership to the customer does not pass pro rata albeit he finds the results much closer to that ideal compared with other models (PP. 70-74). For this demonstration Nabil uses what he calls the dynamics of outstanding balances in Islamic home financing models. The objective of this small note is to correct this misconception about the ZDBM.

To open the discussion, let me reiterate that what I call the pro rata transfer of ownership to the customer is the epitome of justice in Islam. Justice means equality before the law: the Scripture does not permit withholding from the people what rightfully becomes due to them. A tradition says pay the wages of the worker before his sweat dries up. The Qur'an unequivocally instructs the believers not to usurp each other's property using unjust means (2:188 and 4:29). Thus, the transfer of property at a rate slower than the payment rate must possibly be avoided. We shall demonstrate that the ZDBM meets that norm to perfection.

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² A draft of the paper which appeared in the ISRA Journal was submitted to the Ninth International Conference on Islamic Economics and Finance held at Istanbul on September 9-10, 2013. The Academic Committee declined to accept the paper for presentation communicating the opinion of a reviewer that the ZDBM is also based on interest. A demonstration could have helped the author to defend or change his position.

Nabil's claim is based on a misinterpretation of the dynamics of outstanding balances. The following section provides a clarification on the point.

2. THE DYNAMIC BALANCE

The argument in Nabil centers around the changing balance of the payment that remains outstanding as installments are progressively paid until this balance due is reduced to zero. This is the basic and common point in all deferred payments contracts using Excel formula, housing included. The crucial point here is how to define the outstanding balance. Should the definition of deductible payment to find this balance with reference to ownership transfer be the sum of (i) the amount of capital returned plus (ii) the return on capital after each installment is paid or it should include only the first of these two elements? The basic difference between Nabil and the present author is on this point. In his dynamic balance Nabil includes both to arrive at the outstanding balance. On this criterion he finds the BBA model of home financing alone meeting the ideal; home ownership transfer to the client pro rata as his Figure 1, on page 72 shows.

The reason is that in the BBA the total amount payable to the bank is settled once for all. The periodic installment is calculated by inserting the principal (P_0) the agreed rate of return (r) and number of time units (n) into the Excel formula. The sum of installments that is the principal amount plus the full period return on it became a loan via a buyback provision in the contract. In BBA, it was this conversion of return on capital into debt that led banks into trouble when in a case of breach or early offer of settlement the amount they claimed as unpaid was challenged as unjust in law courts. Later the grant of *ibra* (discount) in such cases was introduced into the picture to overcome the difficulty and provide relief to the customers.

The case of the BBA apart, it is prima facie illogical to merge the return of capital with the return on capital to discuss the issue of ownership transference to the customer. Return on capital is not a variable that exists independent of the return of capital. The bank focus is the latter alone; as long as capital remains unpaid interest accrues on the balance remaining unpaid. If the loan is cleared before time the interest payment stops simultaneously.

Thus, the relevant deduction for calculating the outstanding balance each time is only the return of capital. In a case of breach of contract, the bank will in the MMP model as in the conventional, will not accept from the sale proceeds of the property less than the part of capital that remains unpaid, assuming for simplicity that the market price of the house remains unchanged. On this view of what Nabil the *dynamic balance*, only the ZDBM meets the pro rata transference ideal; the MMP model does not. We have shown it earlier but we reproduce it here for completion of this brief note using the same illustration that we used earlier writings and which our critics also found convenient to use for comparison.

3. OWNERSHIP TRANSFER – MMP versus ZDBM

In bare bones the illustration that Nabil also uses is as follows. The value of the house is \$100,000 of which the customer contributes \$20,000 and the bank provides the remaining \$80,000 for 10 years payable in 20 uniform semi-annual installments. In the MMP the semi-

annual installment is as usual calculated using the Excel formula at \$5886.54. The amount includes both the return of capital and the return on capital components. It is this notion of installment payment that lies at the heart of Nabil’s analysis. However, the ZDBM vies the payments differently. It talks of the uniformity in the return of capital only i.e. \$4000 semi-annually. The *murabahah* mark-up at 8% per annum replaces rental and is *segmental* i.e. applied to the diminishing balance at each time point. Thus, the total payment – return of capital plus return on capital – per period does not remain uniform as in the ZDBM. Table 1 compares the two positions.

Table 1: Ownership transfer: MMP versus ZDBM

Semi annual periods	MMP				ZDBM			
	Return on capital	Return of capital	Outstanding Balance (80,000 – B)	Total payment (A + B)	Return on capital (G*.04)	Return of capital	Outstanding Balance (80,000 – n*F)	Total payment (E+F)
n	A	B	C	D	E	F	G	H
1	3200	2687	77313	5887	3200	4000	80000	7200
2	3093	2794	74520	5887	3040	4000	76000	7040
3	2981	2906	71614	5887	2880	4000	72000	6880
4	2865	3022	68593	5887	2720	4000	68000	6720
5	2744	3143	65450	5887	2560	4000	64000	6560
6	2618	3269	62182	5887	2400	4000	60000	6400
7	2487	3400	58782	5887	2240	4000	56000	6240
8	2351	3536	55247	5887	2080	4000	52000	6080
9	2210	3677	51571	5887	1920	4000	48000	5920
10	2063	3824	47748	5887	1760	4000	44000	5760
11	1910	3977	43771	5887	1600	4000	40000	5600
12	1751	4136	39636	5887	1440	4000	36000	5440
13	1585	4302	35335	5887	1280	4000	32000	5280
14	1413	4474	30862	5887	1120	4000	28000	5120
15	1234	4653	26209	5887	960	4000	24000	4960
16	1048	4839	21370	5887	800	4000	20000	4800
17	855	5032	16338	5887	640	4000	16000	4640
18	654	5233	11105	5887	480	4000	12000	4480
19	444	5443	5662	5887	320	4000	8000	4320
20	227	5660		5887	160	4000	4000	4160

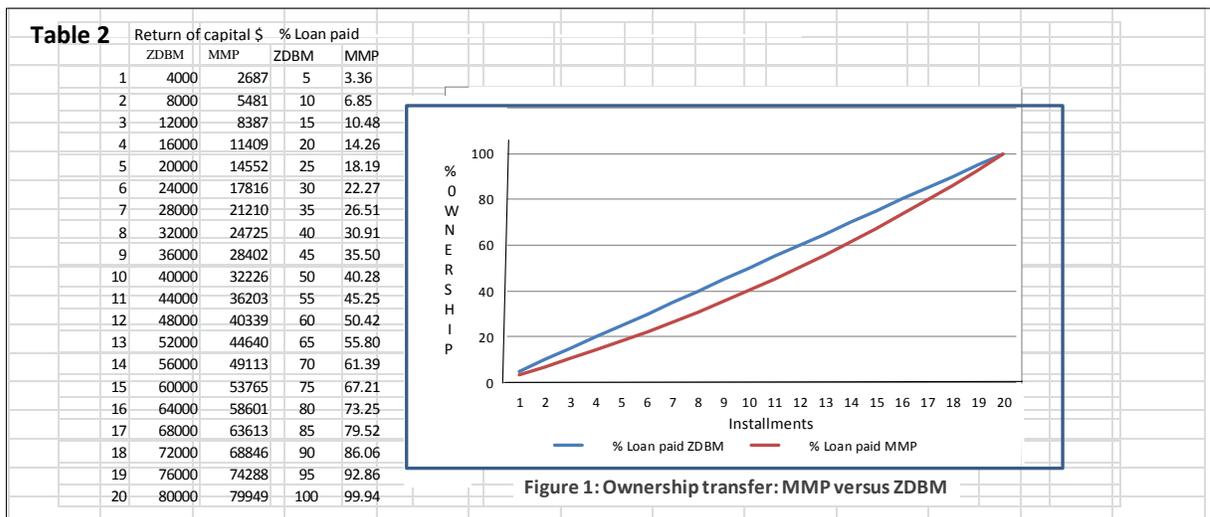


Table 2 has been derived from Table 1 and Figure 1 is its graphic depiction. The straight line in the Figure shows the pro rata transfer of house ownership to the customer. In other words, at each point of the line we have:

$$\frac{\text{Cumulative Amortization ratio}}{\text{ownership transfer ratio}} = 1$$

This is what happens under the ZDBM. In contrast, under the MMP cumulative amortization ratio remains less than pro rata transfer ratio =1 as shown by the gap between the curve and the straight line until the last (20th) payment has been made. The lapse is serious from the Islamic viewpoint and must keep the contract inequitable and therefore void all along the line.

If the above argument is acceptable, the well-constructed conceptual framework of Nabil presenting several hybrid models may possibly need a relook as the total payment – return of capital + return on capital – is the basis of his argument.

References

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