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Risk Management of *Musyarakah Mutanaqisah* Contract in Sharia Banks in Indonesia: Legal and Operational Issues

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ABSTRACT

This paper discusses how to solve problems occurring in the risk management of *musyarakah mutanaqisah* contract on home financing in sharia banks in Indonesia, particularly on its legal and operational issues. This study used a qualitative method using library data collection techniques and interviews. The study found that legal and operational risk management issues could be satisfactorily resolved by agreement of rescheduling, adding new conditions, and using new structures in accordance with Islamic teachings and applicable positive laws. In addition, ownership proof of some is needed to minimize the risk for the bank and the customer.

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Keywords: Legal Issues, *Musyarakah Mutanaqisah* (MMQ) Contract, Risk Management, Operational Issues

INTRODUCTION

Sharia banking system requires Islamic values as the basic guideline for its operations (Alsmadi & Zarour, 2015), procedures and mechanisms making people feel the stark contrast between conventional banks and Sharia banks (Buallay, 2019), and lift public confidence in Sharia banking (Salman & Nawaz, 2018). Islamic values are certainly not merely a symbolic representation yet norms to apply in Sharia banking activities, particularly their Sharia banking products (El-Ghattis, 2011). *Musyarakah mutanaqisah* is one unique sharia banking product yet contradictory in their application. This scheme is generally used for home financing.

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The Financial Services Authority as an institution with functions, duties, and authorities to regulate, supervise, inspect, and investigate all financial institutions in Indonesia outline the specifications of *musyarakah mutanaqisah* contract (MMQ) in Indonesia sharia banking (Otoritas Jasa Keuangan (OJK), 2016a), implemented to finance the purchase of new or old properties, overtaking and refinancing, and home financing. The properties are housing estates, flats, shophouses, home offices, apartments and condominiums. While in terms of the period, MMQ is valuable for both medium-term or long-term financing. This is an interesting contract for housing estate financing and an alternative for *murabahah* scheme of sharia residential property / *bai 'bi tsaman ajil* (Meera & Razak, 2009). Based on the latest sharia banking statistics in March 2019, financing housing ownership of sharia commercial banks and sharia business units reaches 73,256 billion with Non Performing Finance (NPF) ratio of 1,622.

Profit-Loss Sharing in *musyarakah mutanaqisah* (MMQ) requires excellent risk management of sharia commercial banks, sharia business units, sharia rural banks in line with religious values (Trad et al., 2017) to avoid deviation to the agreed sharia banking regulations (Alam et al., 2019). Moreover, sharia commercial banks, sharia business units, and sharia rural banks must withhold their funds from third party depositors. Therefore risk management system effectively applied in the whole MMQ process is deemed necessary.

However, there is a yawning gap of MMQ application in Indonesian sharia banking between practice and theory. This makes people perceive sharia banks are on a par with conventional banks. This gap creates real impacts on public trust in MMQ financing. Thus, the analysis is to find solutions that are relevant for the company is necessary (Wen et al., 2019), and as a form of social responsibility (Alfahad & Quttainah, 2018) based on Islamic values.

Discussion on MMQ is based on partnerships with revenue sharing such as *Musyarakah* and *Musyarakah Mutanaqishah* in Indonesia with their minor growth compared to other products. In December 2017 *Musyarakah* was recorded to only have a portion of 28.50% of the total sharia banking financings. It should be a superior product due to its uniqueness compared to conventional bank products (Buku, 2016). The results showed that the major issue in constrained product development of MMQ house financing by ANP Method, according to experts, practitioners and regulators is a matter of legal / structural issues (Bangsawan et al., 2018).

Besides, operational issues in MMQ related to financing risks is vital (Türsoy, 2018). It is the result of customer failure to fulfilling their obligations or they default on the terms of the contract. MMQ financing is a high-risk profile since capital participation is equated with a portion for profit and loss. In other words, it is also equivalent to risk coverage according to the portion of capital participation of each party.

There are three stages in MMQ financing, namely pre-contract, contract term, and contract completion. Problems occur in the initial process and during the contract. On the other hand, sharia banking must deal with this issue increasing the number of their consumers (Hanudin, 2014).

This study explores effective actions in dealing with issues of risk management in *musyarakah mutanaqisah* financing which generally occurs in sharia financial institutions in Indonesia. The novelty in this paper lies in its contribution to bridge the gap between practice and theory in the current practice of *musyarakah mutanaqishah* in Indonesia, with legal and operational issues in particular and its solutions for handling these problems.

Asadov et al., (2018) discussed some important practical issues of *musyarakah mutanaqisah* in their study. Several previous studies also talked out of this topic, such as *mutanaqisah musyarakah* rental index rates (Mohd, 2016), *musyarakah mutanaqisah* in a sharia cooperative (Norbaizurah, 2018), *musyarakah mutanaqisah* Contract Risk in Malaysia (Idris, 2018), restructuring the lease component for more innovative sharia compliance products in sharia housing financing (Mahfudz et al., 2016), implications of *musyarakah mutanaqisah* (Subky et al., 2017), and *musyarakah mutanaqisah* house financing for labor affordability (Eam et al., 2019).

Those studies have mainly focused more on problem analysis of MMQ financing in general context and the solution. However, a deeper exploration regarding legal and operational issues that occur in the implementation of MMQ in Indonesia is of necessity.

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Musyarakah or *syirkah* linguistically means *al-ikhtilat* or merging or mixing. According to the scholars of *fiqh*, *syirkah*, in terms of a combination of assets, refers to business capital and the results in the form of profits or losses shared (Syabiq, 2000). Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) defined *musyarakah* as a form of partnership in which one partner promises to buy equity shares from other partners in stages until the rights to equity are truly achieved and transferred. This transaction begins with the formation of a partnership, after which the purchase and sale of equity are made between the two partners. Therefore, these purchases and sales should not be regulated in a partnership contract. In other words, buyer partners are only allowed to make promises to buy. This promise must be independent of the partnership contract. In addition, the sale and purchase agreement must be independent of the partnership contract. It is not permitted that one contract is made as a condition for concluding the other (*Shari'ah*, 2008, p. 217).

The term *musyarakah* does not exist in Islamic jurisprudence. It was originally introduced by those who write about Shariah financing schemes which were limited to certain types of *syirkah*, namely *syirkah al-amwal*, an admissible covenant by all Islamic scholars. *Musyarakah* is a profit-sharing agreement in which two or more entrepreneurs with funds/capital work together as business partners, financing the investment of new or existing businesses. Business partners owning the capital have the right to participate in company management, although its is not required (Salehuddin & Saiti, 2016). The parties can divide the duty of the business management according to the agreement and they might also ask for salary/wages for labors and expertises they devote to the business.

According to Nasim & Mediawati, (2019), *musyarakah* is about a contract of cooperation among capital owners who mix their capital for profit-making purposes. In *musyarakah*, partners and fund owners, for example, banks, jointly provide capital to finance particular existing or new businesses. Furthermore, partners may return the capital, along with the agreed profit sharing, to the Bank. *Musyarakah* could be permanent or decreasing. In a permanent *musyarakah*, parts of each partner is determined according to the contract and the amount remains until the contract expiration. In the decreasing *musyarakah*, the share of the fund capital owner or bank is gradually transferred to the partners. This decreases the share of the fund capital owner and at the expiration, the partner will become the owner of the business. *Musharakah* profits are shared between the parties, either proportionally to the paid-in capital or under certain agreed amounts. While the loss is charged proportionally to the paid-in capital.

The practice of *musharakah mutanaqishah* (MMQ) has been carried out iB Muamalat Home Ownership Credit product under Bank Muamalat Indonesia, Tbk. In this product, Bank Muamalat offers two different schemes, namely *Murabahah* and *Musyarakah Mutanaqishah*. Customers may choose which contract suitable with their wishes and conditions. These contracts accommodate other things which cannot be accommodated by other contracts such as *murabaha*. *Musyarakah mutanaqishah* could be applied in a financing scheme in sharia banks, especially for asset ownership, such as residences.

The implementation flow of this scheme is outlines as follows:

1. Customer choose the type of houses they want by *musyarakah mutanaqisah* scheme
2. Banks or other external parties (Property Appraisal Service Offices) valueate the houses. This valuation is required since the house is used as a *dhaman* or collateral for the financing.
3. After the price is determined and its value meets the banking requirements, the customers must complete the financing documents, such as personal data, income data, and collateral data.
4. After the customer data collection, the bank verifies and analyze customers ability to pay (cash ratio) and guarantee coverage. Then, the bank determines the financing ceiling, the number of installments, and the financing period.
5. After the approval, the bank sends an Approval Request for Payment (SP3) or Offering Letter (OL) to the customer for later signing.
6. The customer makes a down payment (DP) to the developer/seller of the house. The downpayment is a portion of customer's *syirkah* in *musyarakah* for homeownership.
7. The customer and the bank enter into a mutually funded *musharakah* financing agreement for the house. The contract used is *musyarakah*, *bai'* and *ijarah*.
8. After the contract is made, the bank pays the remaining balance for the purchase of the house. The contract of purchasing houses is made by paying 100% of the *syirkah* portion.
9. The customer pays monthly installments to the bank for a specified period. The installment functions as:
 - a. rent money (customer's *ajr* for the placement of houses (*musharakah* assets).
 - b. object of profit sharing for the *musyarakah* contract, collected according to the portion of profit sharing agreed within the contract.
 - c. Some of the rent profit of the profit-sharing ratio is not taken by the customer, but for the purchase of a portion of the bank's ownership of the house. Then the customer pays monthly installments, it increase his/her portion of ownership and reduce the bank's (*mutanaqishah*)
10. If the period expires and the customer has paid all of his/her monthly payments, the entire portion of homeownership is fully transferred to the customer. Thus, the bank releases the underwriting right on housing guarantees (by Roya).

Figure 1 below provides the summary of those whole processes.

Figure 1. Summary of Typical MM Home Financing Structure and Operation (Asian Institute of Finance (AIF), 2013)

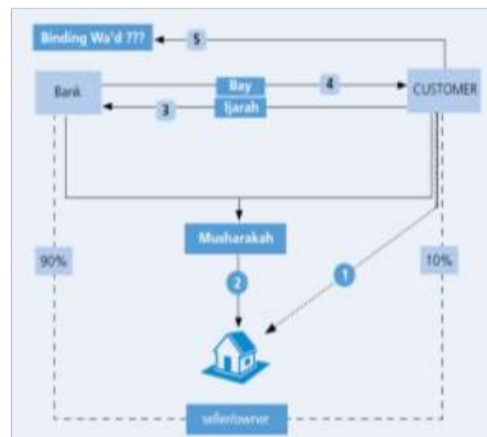


Figure 1 describe the structure and operation of MM Home Financing as follows.

1. The customer selects the house and applies for bank financing.
2. The bank approves the application and enters into *musyarakah* agreement with customers jointly purchase and own the house with e.g. 90:10 ratio.
3. The customer leases the bank's share in the house (*ijarah*) & makes periodic rental payments.
4. The customer buys portions of ownership of the house from the bank until gradually the bank sells all its portions to the customer who then fully owns the house.
5. Some banks will ask the customer to give it a binding promise (*wa'd*) to purchase the *Musharakah* asset.

RESEARCH METHOD

This study used qualitative research methods with qualitative descriptive analysis techniques. The primary data sources included semi-structured interviews conducted with several informants selected based on their expertises in sharia banking in Indonesia. The secondary data were obtained by reviewing of qualitative documents obtained from *musyarakah mutanaqisah* (MMQ) transaction documents in Indonesia. At last, textual analysis was used to identify and describe the purpose of the message within the text (Frey et al., 2000).

RESULTS AND DISCUSSION

Based on the results of the analysis of legal and operational issues on the implementation of *musyarakah mutanaqisah* (MMQ) products in Indonesian sharia banking. Table 1 below presents the summary.

Table 1. Legal and Operational Issues of MMQ Agreement in Indonesia

Legal Issues	Operational Issues
<ul style="list-style-type: none"> The difference in the rules of <i>fiqh</i> with positive law Indonesia related to registration of ownership certificate The weak legal position of sharia banks restraining them to use a debit statement, and mortgage rights (APHT) for ownership transferring Fatwa of DSN, and PBI or SEBI Fatwa have not yet been sufficiently completed to regulate the substance of sharia banking agreements required by a notary or sharia bank. 	<ul style="list-style-type: none"> Banks tend to immediately execute collateral due to customer's failure to meet rent obligations without consumer's consent when financing <i>musyarakah</i> accompanied by the transfer of ownership. Transfer of all payment obligations costs incurred to customers deviates from AAOIFI standards and Fatwa of DSN No.73 / DSNMUI / XI / 2008

Source: Otoritas Jasa Keuangan (OJK), 2016b)

Table 1 implies that after observing the current implementation of the *musyarakah mutanaqishah* and reviewing the general provisions of this contract, we can perceive that there are gaps in practice and theory.

Firstly, as the contract is made, the next process is title transfer of the house (asset) to one of the parties, namely the customer. The bank also owns the asset, even its initial portion is much greater than the customer. There is no authentic proof of bank ownership of the *musyarakah* assets on the asset certificate.

To deal with this, customers, and banks need to have ownership proof of the assets. Compilation of Sharia Economic Law (KHES) Book II Article 46 stated that a contract is only valid among parties of the contract (Solihin & Suarsa, 2019). This means that the MMQ contract is as legal subjects in the agreement. Furthermore, writing the name of the customer in possession of the asset certificate is only an effort of shariah to simplify and avoid double costs. This concludes that regarding the problem of ownership of assets in the name of the customer is not a proof that the financing object has been fully owned by the customer, however it is merely to facilitate customers in the transfer of the object. This is not necessary to do several times. It is simply at the first time directly in the customer's name. This is under the principle of contract and agreement freedom whereas written evidence confirming of bank ownership remains applicable until the customers complete their obligation.

Mutanaqishah musyarakah has consequences that each owner should have legal proof of the asset ownership by certificates. However, the certificate cannot be made in the name of two legal subjects, so the regulation of this matter is left to the burden itself. The object jointly purchased is shared since there is still another portion of sharia banks.

Secondly, tax expenses, such as Sales Tax, Acquisition Duty of Right on Land and Building (BPHTB), Title Transfer Fee, etc., are fully borne by the customers, not by both parties.

To handle this, administrative costs can be determined based on the needs of binding process of *musyarakah mutanaqisah* to provide clarity of administrative costs details and the bank can also be responsible. In addition, expenses for the engagement, such as notary fees and insurance, should be shared because they are part of the ownership of the object. The administrative costs, based on the interviews results, can be charged to customers since these costs are made for operational processes. It is used for the determination of administrative costs which should not be based on the percentage of the funding ceiling, which is equal to the profit-taking set in conventional banks on credit financing. For this reason, administrative costs should be determined originated from the needs of the contract process. Investment decisions and indirect investment decisions can be approved to assess companies (Murniati et al., 2019) as partners of the loan. Thus, determining the administrative costs should be carefully considered.

Openness to details of administrative costs is highly crucial since administrative costs are charged to customers. This is to make the designation clear and accounted for. Imposing all costs unilaterally to the customer is unnecessary even though this does not make *musyarakah mutanaqisah* invalid, however this involves injustice, in which the customers themselves must bear the entire cost. This can lead to a decrease in customer capital and is contrary to Islamic economic principles of justice, as the Quran surah *al-Nahl* verse 90 stated "*Indeed, Allah commands justice, grace, as well as courtesy to close relatives. He forbids indecency, wickedness, and aggression. He instructs you so perhaps you will be mindful.*"

Fair means good and balanced. There is an imbalance in *musyarakah mutanaqisah*, in which all costs were borne unilaterally by the customers. These should be borne jointly by both the customers and the banks since these costs are included in the acquisition cost of the mutant assets of the mutants. A hadith from Muhammad bin Abdullah bin al-Mutsanna read "... that Abu Bakr radiyallahu'anhu set alms obligations to him as the Messenger of Allah Saw has required it. He said: "And the two men who have mingled (the two livestock) should make peace with the same burden".

The hadith above underlined that if two assets have been mixed, both must bear the burden arising from the engagement. Therefore, in the case of an agreement between a customer and a sharia Bank with a *musyarakah mutanaqisah* contract, the costs incurred should be borne jointly. Besides, the contract is a cooperation agreement, which in its implementation should proportionally share the costs and benefits.

Thirdly, if bad financing occurs, and *musyarakah* (house) assets are on sale, with the following processes.

- a. If the selling price of the house is greater than the remaining outstanding principal (the remaining portion owned by the bank), the proceeds of the sale are used to cover the remaining outstanding first, then the rest is given to the customer. This is contrary to the principle of profit sharing and loss in *musyarakah*. Based on its principle in which the partners obtain profits based on the agreed ratio within the contract period and bear the loss per the proportion of capital compared to the sale conditions of these assets. The proceeds from sales are prioritized to cover outstanding principal (bank's portion). The rest or the profit of selling assets is not entirely given to the customer. It must be proportionally shared according to the profit-sharing agreement.

- b. If the selling price of the house is less than the remaining outstanding principal (the remaining portion of the bank) then the entire sale proceeds are used to cover the remaining outstanding. If the outstanding remains, the customers must pay the shortfall or if it is unable, it becomes the bank's burden. This also contradicts the principle of profit sharing and loss in *musyarakah*. Based on the *musyarakah* principle in which the partners obtain profits based on the agreed ratio and bear the loss by the proportion of capital. Proceeds from sales are prioritized to cover outstanding principal (bank portion). The remaining outstanding which is not covered by the proceeds of the seller must be proportionally shared to both parties, according to the portion of ownership before selling the collateral (the last portion).

The above discussion of several settlements, it is obvious that to realize cooperation and to fulfill the needs of each party, in the banks and the customers are required to have their openness and separate strategies for managing risks. The bank's responsibility for the completion of the contract is one of the determining factors of the company value (Sunarsih et al., 2019). In particular, banks influence people's judgment, as a form of trust from people in the company. Therefore, sharia banks need to involve each stakeholders in the decision-making process (Alsbaity, 2018) to improve MMQ services for customers. In addition, customer's sufficient knowledge is beneficial to facilitate them to interact with the banks when applying for home financing with an MMQ contract.

CONCLUSIONS

Customers and banks should take risk management into consideration to deal with legal and operational issues on *musyarakah mutanaqisah* contract for home financing. To handle this, deliberations and consensus, for rescheduling, reconditioning, restructuring, should be high priority. In addition to anticipating and minimizing the risks during the contract or after the contract terminates, banks should apply the precautionary principle, to ensure their healthy condition, liquidity, solvency, and profitability. This is to maintain public trust allowing the community to willingly save their funds in the banks.

On the other hand, the customers should first comprehend each contract in *musyarakah mutanaqisah*, how to deal with the problematic financing and regulations to avoid future disadvantages. Since this study mainly focuses on risk management issues, especially legal and operational issues of *musyarakah mutanaqisah* for home financing, this study does not entirely come up with solution of all sharia issues on *musyarakah mutanaqisah*.

Furthermore, the findings are limited to MMQ issues in sharia banks in Indonesia. To get better and more representative results, further research shall focus on the risk management associated with MMQ in other countries. Other future studies might focus to examine MMQ risk management issues of sharia issues, for example, MMQ objects / goods used as collateral, the principle of two-contract-in-one-item when the lease and purchase contracts are agreed at the same time.

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