Quarterly Research Journal "Al-Marsoos", Volume 02, Issue 04, Oct-Dec 2024

AL-MARSOOS

ISSN(P): 2959-2038 / ISSN(E): 2959-2046

https://www.al-marsoos.com

Diminishing Musharakah in Islamic Commercial Law: Reassessing Ownership, Contractual Independence and Risk Allocation

ABSTRACT

Diminishing Musharakah has become an important financing mechanism in contemporary Islamic banking, particularly in housing and real estate finance. It generally combines joint ownership of an asset, leasing of the financing institution's share and the gradual purchase of that share by the customer. Although recognised by contemporary Shariah standards, its permissibility depends on compliance with the principles governing ownership, partnership, leasing, sale and contractual obligations. This study examines Diminishing Musharakah from the perspective of Islamic commercial law, focusing on three central issues: genuine ownership, contractual independence and the allocation of ownership-related risks. Employing a qualitative, doctrinal and analytical methodology, it examines Qur'anic principles, Prophetic teachings, classical Islamic jurisprudence, relevant AAOIFI standards and the State Bank of Pakistan's regulatory framework. The study argues that Diminishing Musharakah is not an independent nominate contract in classical Islamic jurisprudence but a contemporary arrangement comprising several recognised contracts. Its validity therefore requires each constituent contract to fulfil its own Shariah conditions. The study further maintains that contractual independence must be substantive rather than merely documentary. It proposes a five-dimensional framework for assessing compliance, covering ownership authenticity, rental entitlement, effective transfer of ownership, proportionate risk allocation and contractual independence. It concludes that Diminishing Musharakah can provide a legitimate Islamic financing alternative only when the financing institution assumes the rights and responsibilities arising from its actual ownership.

Keywords: *Diminishing Musharakah; Islamic Commercial Law; Shirkat al-Milk; Ijarah; Bai; Ownership; Contractual Independence; Risk Allocation.*

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Date of Submission: 28-11-2024
Acceptance: 07-12-2024
Publishing: 20-12-2024

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

Islamic commercial law provides a comprehensive framework for economic and financial transactions. Its fundamental principles include the prohibition of Riba, mutual consent, transparency, and fulfilment of contractual obligations, justice and the avoidance of unjust enrichment. These principles govern not only the formal structure of transactions but also their legal and economic substance.

Contemporary Islamic banking has developed various financing mechanisms to meet modern economic requirements while maintaining conformity with Shariah. Diminishing Musharakah is among the most significant of these mechanisms, particularly in housing and real estate finance. Under this arrangement, a customer and an Islamic financial institution jointly acquire an asset. The customer subsequently purchases the institution's ownership share in stages. Where the asset is leased, the customer also pays rent for the usufruct of the institution's share. The arrangement generally involves three contractual components: joint ownership (Shirkat al-Milk), leasing (Ijarah) and successive sales (Bai). Although each is recognised in Islamic jurisprudence, their combination raises important questions concerning ownership, contractual independence and the allocation of risks.

The central concern is whether the financing institution becomes a genuine owner and accepts the liabilities associated with ownership, or whether its participation is merely formal. Similarly, the sale of ownership units must produce actual legal consequences rather than function merely as an accounting adjustment to a financing balance.

This study therefore reassesses Diminishing Musharakah through the principles of Islamic commercial law, with particular reference to the Pakistani regulatory framework.

2. Research Problem

The principal research problem concerns whether the practical implementation of Diminishing Musharakah preserves the legal and economic substance of its constituent contracts. In particular, questions arise regarding the genuineness of joint ownership, the validity of leasing a jointly owned share, the effectiveness of successive sales and the allocation of ownership-related liabilities.

The issue is not simply whether Diminishing Musharakah is permissible in principle, but whether its actual contractual implementation fulfils the requirements of Islamic commercial law.

3. Conceptual and Jurisprudential Foundations

Conceptual and Jurisprudential Foundations are the following.

3.1 Nature of Diminishing Musharakah

Diminishing Musharakah is a contemporary financing arrangement in which two or more parties jointly own an asset, while one party gradually purchases the ownership share of the other until complete ownership is transferred.

In housing finance, the customer contributes part of the purchase price and the bank provides the remaining amount. Both parties acquire ownership in agreed proportions. The customer may lease the bank's share and pay rent for its use. Over time, the customer purchases the bank's ownership units.

The arrangement therefore consists of three principal elements:

- Joint ownership (Shirkat al-Milk).
- Leasing of the bank's share (Ijarah).
- Gradual purchase of ownership units (Bai).

The Shariah validity of the arrangement depends on the independent fulfilment of the conditions applicable to each component.

3.2 Shirkat al-Milk and Shirkat al-Aqd

Islamic jurisprudence distinguishes between Shirkat al-Milk and Shirkat al-Aqd.

Shirkat al-Milk refers to joint ownership of a specific asset by two or more persons. It may arise through purchase, inheritance, gift or another recognised legal cause. Each owner possesses an interest in the asset according to the established ownership shares.

Shirkat al-Aqd, on the other hand, is a contractual partnership established for a commercial purpose. Its rules concern the parties' contributions, business activity, distribution of profit and allocation of loss.

Diminishing Musharakah in housing finance is generally based on Shirkat al-Milk. The bank and customer jointly own a particular property, and the customer gradually acquires the bank's share. This distinction matters because the legal consequences of joint ownership are different from those of a commercial partnership.

AAOIFI Shariah Standard No. 12 addresses Sharika (Musharakah) and Modern Corporations, whereas the SBP has issued a specific standard for Sharikat ul Milk and Diminishing Musharakah. The rules governing these two structures should not be treated as interchangeable.

3.3 Qur'anic and Prophetic Foundations

The Qur'an establishes the fundamental distinction between lawful trade and prohibited Riba:

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

"Allah has permitted trade and forbidden Riba."

This verse establishes the permissibility of lawful trade and the prohibition of interest-based transactions. Diminishing Musharakah seeks to structure property finance through genuine ownership, leasing and sale rather than an interest-bearing loan.

The Qur'an also emphasises mutual consent:

إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِنْكُمْ

"Except through trade conducted by mutual consent."

Furthermore, Allah commands:

أَوْفُوا بِالْعُقُودِ

"Fulfil your contracts."

These principles require clarity in the parties' contractual rights and obligations. The bank must fulfil its responsibilities as an owner and lessor, while the customer must fulfil the obligations arising from the lease and successive purchases.

The Prophet Muhammad ﷺ stated:

الْمُسْلِمُونَ عَلَى شُرُوطِهِمْ

"Muslims are bound by their conditions."

This principle supports lawful contractual conditions, provided that they do not contradict Shariah. An agreement cannot make a prohibited transaction permissible merely because both parties have consented to it.

4. Ownership, Leasing and Transfer of Shares

4.1 Ownership and Entitlement to Benefit

Ownership is a fundamental basis for entitlement to the benefits of an asset. A recognised jurisprudential maxim states:

الْخَرَاجُ بِالضَّمَانِ

"Entitlement to benefit is linked to liability."

This maxim establishes an important relationship between the right to derive benefit from an asset and responsibility for its ownership-related risks.

In Diminishing Musharakah, the bank's right to receive rent arises from its ownership share and the valid leasing of the corresponding usufruct. The bank must therefore possess genuine ownership before claiming rental income.

Ownership should not be merely nominal or confined to the wording of an agreement. It should be legally established, identifiable and supported by appropriate documentation. The bank's ownership responsibilities must also be recognised in the contractual arrangement.

The principle does not mean that every expense must be divided identically between the owner and user. Rather, ownership expenses, structural maintenance and ordinary operational costs must be distinguished according to their legal nature.

4.2 Leasing a Jointly Owned Asset

Ijarah is a recognised contract in Islamic jurisprudence. It involves the transfer of a lawful and identifiable usufruct for a known consideration and specified period.

In Diminishing Musharakah, the bank may lease its ownership share to the customer, subject to the requirements of a valid lease. The essential conditions include:

1. The lessor must possess a valid ownership interest in the asset or share.
2. The usufruct must be lawful and identifiable.
3. The rental consideration and relevant period must be sufficiently clear.
4. Ownership-related liabilities must remain with the lessor where required by Shariah.
5. Ordinary operational expenses may be borne by the lessee according to the applicable rules.

Classical jurists discussed the leasing of undivided shares (al-mushāʿ), including the circumstances in which a share may be leased to a co-owner or another person. The ruling may depend on the nature of the asset and the possibility of identifying the usufruct.

The SBP standard specifically recognises the leasing of a joint owner's share to another joint owner. It distinguishes structural maintenance, which remains the responsibility of the owner, from operational expenses, which are borne by the lessee.

Thus, leasing the bank's share is permissible when ownership and the requirements of Ijarah are genuinely established.

4.3 Gradual Sale of Ownership Units

The gradual purchase of the bank's share must constitute genuine sale transactions. Each sale should fulfil the general requirements of Bai, including:

- Ownership of the share by the seller.
- Identification of the subject matter.
- Mutual consent.
- Clarity of the price or its permissible method of determination.

- Effective transfer of ownership.

The purchase of units should not be treated merely as an accounting adjustment to an outstanding financing amount. Each transaction should produce a corresponding legal transfer, reflected in the ownership records.

The SBP standard permits a purchase undertaking based on face value, book value, agreed value or market value, subject to the requirements of the standard and the independence of the undertaking from the joint ownership contract. The relevant rules must be applied to the specific Shirkat al-Milk structure rather than automatically importing rules designed for a different form of partnership.

5. Contractual Independence and Risk Allocation

5.1 Independence of Contracts

Diminishing Musharakah combines several contractual relationships, but each must retain its own legal character.

The joint ownership agreement establishes the parties' ownership interests. The Ijarah agreement governs the lease of the bank's share. The purchase undertaking provides the framework for gradual transfer, while each actual purchase must constitute a valid sale.

The commercial connection between these contracts does not necessarily invalidate them. The essential requirement is that their legal conditions and consequences remain consistent with Shariah.

AAOIFI Shariah Standard No. 25 addresses the combination of contracts and provides guidance concerning composite contractual arrangements. The SBP standard likewise requires the relevant sale and purchase arrangements to remain independent of the joint ownership contract.

Therefore, separate documents alone are insufficient. The actual implementation must demonstrate that:

1. Joint ownership is established before rental entitlement arises.
2. Rent is charged only for a validly leased ownership share.
3. Each purchase of ownership units has an independent legal effect.
4. No contractual condition undermines the requirements of another contract.
5. Actual ownership records and financial transactions correspond to the contractual documentation.

5.2 Risk Allocation and Ownership Responsibilities

Risk allocation is essential to the Shariah validity of Diminishing Musharakah. Where two parties jointly own an asset, ownership-related gains and losses must be allocated according to their ownership shares and applicable Shariah rules.

The following responsibilities should be distinguished:

Ownership expenses: Taxes, levies and other expenses directly related to ownership should be allocated in accordance with the relevant ownership proportions.

Structural maintenance: The owner remains responsible for structural maintenance obligations associated with the ownership share.

Operational expenses: Ordinary expenses arising from the use of the property may be borne by the lessee, subject to the applicable contractual and Shariah rules.

Damage and destruction: Where an asset is damaged without negligence or misconduct, the consequences should be determined according to the actual ownership interests and applicable

rules. Were damage results from negligence, misconduct or breach, the responsible party may be liable.

Takaful: Shariah-compliant Takaful may be used to manage property-related risks, but it does not eliminate the need to identify the parties' underlying ownership responsibilities.

The SBP standard provides for proportionate allocation of gains, losses and ownership-related expenses. It also distinguishes structural maintenance from ordinary operational expenses.

Accordingly, the bank cannot claim the benefits of ownership while transferring every ownership-related liability to the customer.

6. Pakistani Regulatory Framework and Critical Analysis

The State Bank of Pakistan issued the Shariah Standard on Sharikat ul Milk and Diminishing Musharakah through IBD Circular No. 02 of 2013, dated 8 April 2013. The standard became applicable from 1 July 2013.

It provides requirements concerning the establishment of joint ownership, ownership shares, purchase undertakings, allocation of gains and losses, ownership expenses, leasing and maintenance. The SBP Compendium of Shariah Standards, updated to 30 June 2025, incorporates this standard within the wider regulatory framework for Islamic banking.

The regulatory framework is significant because it translates general jurisprudential principles into operational requirements. Nevertheless, regulatory recognition of a financing structure does not mean that every transaction automatically complies with Shariah. Actual compliance depends on its implementation.

The principal issues requiring attention are as follows:

First, genuine ownership: The bank must acquire an identifiable share of the property through a valid transaction. A nominal ownership description cannot replace actual ownership.

Second, valid rental entitlement: The bank's rental income must arise from a valid lease of its actual ownership share. Rent should reflect the changing ownership proportions as the customer purchases units.

Third, effective sale: Each transfer of ownership units must be a genuine sale with an identifiable subject matter, price and legal effect.

Fourth, substantive independence: Separate agreements do not establish compliance if their actual operation contradicts the requirements of ownership, leasing or sale.

Fifth, proportionate risk: Ownership-related expenses and liabilities must correspond to the actual ownership shares and relevant Shariah rules.

These issues demonstrate that the principal challenge is not the theoretical permissibility of the constituent contracts but the preservation of their legal and economic substance in practical implementation.

7. A Five-Dimensional Framework for Assessing Shariah Compliance

Authenticity of Ownership: The bank must genuinely own its agreed share of the property.

Validity of Rental Entitlement: Rent must be charged only for the bank's actual ownership share.

Effective Transfer of Ownership: Each purchase must result in the actual transfer of ownership units to the customer.

Proportionate Risk Allocation: Ownership-related expenses, maintenance and losses must be allocated according to Shariah principles.

Contractual Independence: Partnership, leasing and sale contracts must retain their separate legal requirements and effects.

Note: This five-dimensional framework is proposed by the present study and is not an existing SBP or AAOIFI framework.

This framework provides a practical basis for assessing substantive Shariah compliance. Its application requires examination of contractual documents, property ownership records, rental calculations, ownership-transfer documents, and the allocation of financial liabilities.

8. Findings and Recommendations

8.1 Findings

The study establishes the following findings:

1. Diminishing Musharakah is a contemporary financing arrangement based on recognised Islamic contracts rather than a single independent nominate contract in classical jurisprudence.
2. Its principal foundation in housing finance is Shirkat al-Milk, combined with Ijarah and successive sales.
3. The financing institution must possess genuine ownership before claiming rental income.
4. Leasing a jointly owned share is subject to the requirements of valid Ijarah.
5. Each purchase of ownership units must result in an effective transfer of ownership.
6. Contractual independence is substantive and cannot be established merely through separate documents.
7. Ownership-related risks and expenses must be allocated according to the relevant Shariah principles.
8. The SBP standard provides an important regulatory framework, but actual implementation remains essential to Shariah compliance.

8.2 Recommendations

1. Islamic banks should ensure that joint ownership is genuinely established and supported by appropriate legal documentation.
2. Ownership shares should be clearly identified at the beginning of the arrangement.
3. Ijarah agreements should specify the leased share, rental consideration, duration and responsibilities of the parties.
4. Rent should be adjusted when the customer purchases ownership units and the bank's share decreases.
5. Each purchase of ownership units should be documented as a genuine sale.
6. Contractual independence should be examined in actual implementation, not merely in the wording of agreements.
7. Ownership-related expenses and structural maintenance should be allocated according to Shariah requirements.
8. Shariah supervisory boards should examine ownership records, rental calculations and transfer documentation.
9. Regulatory authorities should encourage periodic operational Shariah audits of Diminishing Musharakah transactions.

9. Conclusion

Diminishing Musharakah represents an important development in contemporary Islamic finance. It provides a mechanism for property acquisition through joint ownership, leasing and

gradual transfer of ownership shares. Its jurisprudential foundations are found in the recognised principles governing Shirkat al-Milk, Ijarah and Bai.

However, its permissibility is conditional. The financing institution must acquire genuine ownership, derive rental income from a valid lease, transfer ownership units through effective sale transactions and accept the responsibilities associated with its ownership. The customer must fulfil the obligations arising from the lease and the purchase of ownership units.

The study demonstrates that contractual independence is not merely a matter of preparing separate agreements. Each contract must retain its own legal character and produce the consequences recognised by Islamic jurisprudence. Similarly, risk allocation must reflect actual ownership rather than being determined solely by the commercial convenience of the parties.

The five-dimensional framework proposed in this study provides a systematic basis for examining substantive Shariah compliance. Ultimately, Diminishing Musharakah can serve as a legitimate Islamic financing alternative only when its practical implementation reflects the principles of genuine ownership, liability, justice and contractual independence.

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