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SHARIAH VIEWS ON MORTGAGE REDUCING TERM ASSURANCE (MRTA) IN MURABAHAH ISLAMIC ASSET FINANCING

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Abstract: Mortgage Reducing Term Assurance (MRTA) is a scheme that functions as a mitigation mechanism for the financing risk especially on the long-term financing. The MRTA cost is borne by the bank's customer who is the borrower. The MRTA cost is about protection of the customer in the event of misfortune such as death or disability. In earlier practice of risk mitigation in Murabahah transactions is fully born by the seller (or bank) until the full payment is settled. In modern practice, the risk is traded and transferred to a third party who views the risk as a commercial value and can be traded as a product of profit-making. This study aims to review the Shariah point of view on the concept of MRTA, transferring of MRTA cost to the other party and customer's responsibility on paying a premium cost. This is a comparative study which applied the views of Muslim scholars from all major *mazahibs* in Islamic jurisprudence and the study also referred to the practices of Islamic banks in Malaysia. The study found that the application of MRTA in risk mitigation of property financing must strictly follow the concept of mutual assistance (*al-ta'min al-ta'awuni*), the transferring of risk is allowed within the concept of non-profitable product. The study also found that the risk premium cost to be paid by bank's customer is allowed by Shariah due to the debt settlement is under the responsibility of bank's.

Keywords: Asset Financing, Islamic Financing, Mortgage Reducing Term Assurance, Murabahah financing[1].

1. INTRODUCTION

The practice of Murabahah financing in Malaysia involves short term and long term financing. The short term financing is a corporate financing which includes cash line facility-I, revolving credit facility-I, letter of credit-I and working capital-I [17]. The period for short term financing is not more than 12 months. The long term financing is more on asset-based financing such as housing, commercial lots, automobiles and land. In general, the conventional banks are the institutions which offer finance services to the customer in a form of borrowings. Nevertheless, under Islamic practice, the Islamic financing institutions (IFI) only offer some sort of trading exercise to the customer, where the bank acts as a trader in financing transaction for their customer. An IFI must own the product first and then only it can sell the acquired product to the customer [28]. In the case of failing to own the product first, the transaction would be characterized as *gharar* (uncertainty) concept of buying and selling. In the modern transaction, the bank would attempt to avoid any risk and financial consequences due to uncertainty and doubt, particularly whether the contract can be delivered by the parties involved or not [16]. In such a case, the bank would ask the customer to get the assistance and support from a third party (insurance company) to avoid the risk (Gafoor, 1999). This newly

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innovated risk mitigation mechanism is called Mortgage Reducing Term Assurance (MRTA). MRTA serves as a guarantor to the financial institution in the event of death or disability of its customers. For the guarantee to take place, the customer will bear a certain charge as a premium cost for the scheme. The premium cost will depend on the size of financing. A financing with collateral may incur smaller premium cost than that of the financing without collateral [1]. The risk management is very crucial especially in the long-term financing, as getting back repayment from customer might be troublesome due to sudden death or disability.

On one hand, no specific research available on the shariah in Mortgage Reducing Term Assurance (MRTA), on the other hand, a number of researches have been conducted on risk management from Shariah viewpoint. One of the issues of risk management in an Islamic banking has been explored by Seyed Nezamuddin [24], he examined the general risk which influences an Islamic banking and the future challenges in promoting further development of IFI in the global market. Naveed Ahmed investigated the determination of the firm's level factors which have significantly influenced the risk management practice of IFI in Pakistan [29]. He selected credit operational and liquidity risks as dependent variable, while size, leverage, Non-Performing Loans (NPLs) ratio, capital adequacy and asset management as explanatory variable. Ahmed found that the size of Islamic bank has significant relationship with financial risks. Sania Khalid and Shehla Amjad evaluated the degree to which IFI in Pakistan use the Risk Management Practices (RMPs) and techniques in dealing with different types of risks [23]. He suggested that the IFI in Pakistan were somewhat reasonably efficient in managing risks where Understanding Risk Management (URM), Risk Monitoring (RM), Credit Risk Analysis (CRA) and RMP are concerned. In spite of everything, a very limited number of researches have done on the Shariah and MRTA. Uzaimah identified the general objectives of *fiqh al-muamalat* and the objective of *al-rahn* as a mortgage in Islamic home financing [27], her research looks into the legal provision on charge documentation and practice. Tariqullah Khan and Ahmam Habib studied about risk management in financial industry, they made a comprehensive research on the risk management in IFI which covers the issues ranging from banking system to money market which also includes the derivative market [26]. Elgari examined the terminology of risk that were discussed in *fiqh* literature, and compared them to the risk in modern financial studies [11], he concluded that there is a significant difference between the two, Elgari also suggested that jurist must benefit the great advance of risk management techniques in finance and develop Islamic theory to deal with the unique concept of risk management [11]. Another study done by Fakihah argued that the IFI must offer Islamic MRTA along with Islamic financing package [12], she also quoted the suggestion from the Shariah advisor regarding the payment of MRTA that the cost should be paid either by cash or required a financing from the bank itself. A.L.M Gafoor investigated the risk premium as a component of cost of borrowing [1], he suggested that the cost should be included in the calculation of cost of borrowing. M Pisol explored the views of Muslim scholars on the components of Murabahah asset financing which consist of cost of fund, overhead cost, risk premium cost and profit margin. He concluded that Islamic banks apply two types of risks in their financing. The risks were business risk (*al-khatar al-tijari*) and natural risk (*al-khatar al-baht*) [19]. This study aims to discuss the Shariah views on the risk premium of Mortgage Reducing Term Assurance (MRTA) which is charged by insurance company and the Shariah views on the bank's customers who bear the cost of premium risk.

2. MURABAHAH FINANCING AND MRTA IN BANKING PRACTICE

According to M Pisol *murabahah* refers to a particular kind of sale and has nothing to do with financing in its original sense. If a seller has agreed with his purchaser to provide a particular commodity with certain amount of profit added to the costs, it is called *murabahah* transaction [18]. The basic ingredient of *murabahah* is that the seller discloses the actual cost which is incurred such as overhead and service costs in acquiring the commodity plus profit margin. *Murabahah* is a form of trust and honor sale. The seller must be honest in his cost calculation and the buyer must trust the seller. The seller should not prepare false statement of the cost. If he does so, and it is known later by the buyer, the contract of sale is considered null and void [22]. To date, *al-murabahah* concept has been developed as a product that is used as a financing facility which is called *al-murabahah li al-amir bi al-shira'*. This concept is widely used in IFI globally including Malaysia [8][9]. The determinants of profit rate in *al-murabahah* asset financing in Malaysia involves several components such as cost of fund, overhead cost, risk premium cost and profit margin. The cost of risk premium appears when the assumption of repayment to the bank is uncertain or may not be settled within an agreed period as the bank will avoid any risk incurred due to the fact that the bank has a responsibility to secure depositor's fund. There are two types of risks in property financing. They are business risk (genuine risk) and mitigation risk. The business risk associates with the original business, where the bank must take precaution of any possibility of loss in their business [19]. In modern application of *murabahah* financing which are now implemented in the Islamic banks, the Mortgage Reducing Term Assurance (MRTA) is used to mitigate customer's risk such as death or Total Permanent Disability (TPD).

3. MORTGAGE REDUCING TERM ASSURANCE (MRTA)

Risk premium is a result of risk management revolution in conventional system, with the purpose to avoid the possibility of loss incurred in financial and banking industry. Previously, risk credit was totally borne by the finance provider until the repayment is done. To date, with the innovation, the credit risk is transferred to the third party where it also has commercial value and profit making [15]. IFI is in the same position with conventional banking institution when offering financing product such as Murabahah asset financing, in which, the IFI has to face the risk credit issues, particularly on the long-term financing which involves a large amount of fund. The existence of risk credit, when there is an expectation of failure in repayment of the loan and the expectation of loss and when the customer fails to repay the loan due to total permanent disability or death [10]. According to Tariqullah Khan the risk credit is based on the possibility of failure from the parties involved to meet the requirement as agreed in a contract although the IFI has to take precautionary measure to mitigate the risks [26], the IFI will draft the policies and requirements for the customer prior to the signing of the contract. Among the actions that could be taken by the IFI is to insist the customer to submit the personal guarantor who can be liable in case of failure in repaying the loan or IFI will introduce an insurance company and risk premium cost that will be borne by the customer. The other way of precaution measurement where IFI may ask the customer to exercise *al-rahn* pledge, whereby the pledged property will be subject of collateral in event of default, in order to settle the loan [27].

Mortgage Reducing Term Assurance (MRTA) is referred to Mortgage Life Insurance. It helps to settle the mortgage loan. MRTA is designed to provide a coverage and protection for customers who take up mortgage loans. It covers the customers against TPD. Initially, it is for an amount equal to the customer's outstanding loan which will be reduced in accordance with the installment payments [25]. In the event of the customers' untimely Death or TPD, MRTA will settle the repayment of the mortgage loan. The scheme will assure that the customers' family is free from indebtedness to settle the outstanding mortgage of the house. The cost of MRTA Premium depends on the sum assured, interest rate, term, construction period, financing premium, and age at next birthday, where the younger age deserves the inexpensive rate of premium. The maximum age practiced in Malaysian Insurance firm is 65, however it is subject to underwriting requirement [25].

The MRTA premium is flexible in terms of mode of payment, and it can even be financed by an individual bank and incorporated into the monthly installment of the mortgage loan. This plan provides the ultimate protection to the participant on the amount financed by the financial institution. In Malaysia, the application of MRTA is still very much dependent on the individual bank [12]. Some of the IFIs have their own schemes while others have to request from independent Islamic insurance companies such as Takaful Ikhlas. Some of the companies further extend the concept into an investment. The concept of MRTA from *takaful* point of view is about mutual assistance among the participants, whereas the *takaful* company functions as a trustee of the fund. To facilitate the fund, takaful company introduces a *wakalah* concept with the intention of getting the participant involvement in the scheme, in which, certain portion of the amount is channeled to investment arms.

4. THE ROLE OF INSURANCE COMPANY

The role of insurance company in risk management is important to mitigate a risk in all form of investments [26]. The participation of an insurance company particularly in a high risk financing is highly required to ensure that customer's payment is guaranteed especially in the event of death or TPD. The scheme of insurance companies not only limited to the above calamity but also covers damage, flood, fire and act. The involvement of insurance company has much assisted the banks in managing their financing risk. For instance, Bank A intends to finance a property of its customer (Bakar) for an amount of RM 500,000, the property costs about RM 300,000. Bank A looks for an insurance company to mitigate the risk for this financing, and the insurance companies are only ready to render their insurance service at 90 percent of total financing amount (RM 450,000), with the premium rate at RM 15,000. Consequently, Bank A has two choices which are either to get an insurance protection or not. If the Bank agrees on the insurance service, they must increase their cost by RM 15,000, and at this stance the bank has reduced its profit from RM200,000 to RM185,000 only. But without insurance service the bank will possibly face the risk in case of Bakar's failure to repay back the loan. The tables below show the profit margin of a bank with insurance service while facing the risk of failure in repayment by the borrower.

Table 1: The Customer Repays the Loan Without Fail

	Items	*RM*
1.	Expected Profit margin of Bank A ($)	200,000
2.	Premium cost	-15,000
3.	Profit margin	185,000

Source: Adjusted from Brian Coyle (2000).

Table 1 shows Bank A expects the profit margin of the financing to be $200,000. But at the same time the Bank has to spend $15,000 for the risk premium cost as a protection in case of customer fails to repay. The Bank will obtain a profit margin of $185,000 if the customer repays the loan without fail. Bank A has a choice either to hire the insurance service or not.

Table 2, shows the calculation of profit margin in the event of Bakar fails to repay the Bank's loan. Bank A still has the opportunity to secure the profit of $135,000 after getting compensation from the insurance company. Bank A has the right to charge the risk premium cost to Bakar. It depends on the agreement between the Bank and the customer. The practice of IFI in Malaysia requested the customer to acquire an insurance service from an insurance company, and the cost will be borne by the customer [19]. According to Brian the insurance company will determine the policy, and it will take several considerations before rendering a service to the customer [10]. In this extent, the insurance company tries to avoid a risky project in which the final consequences will cause big loss the company itself.

Table 2: The Customer Fails in Repaying the Loan

	Items	*RM*
1.	Bank A Cost(RM)	-300,000
2.	Premium cost	-15,000
3.	Insurans	+450,000
4.	Profit margin	135,000

Source: Adjusted from Brian Coyle (2000).

5. SHARIAH POINT OF VIEW ON MRTA

As mentioned earlier, The Mortgage Reducing Term Assurance (MRTA) is a protection scheme for the customer of IFI, especially in repaying the financing fund in the event of death or TPD. In managing the risk normally it refers to a third party in particular the insurance company. The insurance company will take responsibility on behalf of the customer. However the insurance company has no involvement in trading transaction between the bank and the customer. The insurance company is only invited to manage the possibility of risk in the transaction between them. The risk management would become a serious issue especially for business which involves a sizable fund and long term period of financing. The IFI will make an effort to hedge any possibility of loss [26].

Prior to Shariah discussion, the *fuqaha* (Muslim jurist) classified the risks into two categories. The first category, *khatar al-baht* (genuine risk) refers to the natural risk such as accident, flood, disability, death and act. This category of risk is accepted by Shariah to be transferred. The second category, *khatar al-tijari* (business risk) which is referring to the up and down of business activities, thus this category of risk is not permitted by Shariah to be transferred to the third party. The owner of the business must take full responsibility of loss [4], nevertheless the business owner has the right to increase the profit margin as a reflection to the risk involved [14].

The discussion about Mortgage Reducing Term Assurance (MRTA) falls under the first category of risk *khatar al-baht* (pure risk) due to the involvement of natural risk. MRTA as commercial product is based on concept of *al-ta'min al-tijari*. Due to the existence of elements of *gharar* and *riba* in the contract, this type of contract may cause a dispute and conflict in the future [7]. The first discussion about *al-ta'min al-tijari* transaction was done by Ibn Abidin he was asked on *al-ta'min al-bahri,* a practice of a trader who rents a space in a warship where the trader paid certain charges for their traded goods. In getting an extra service, the trader has to pay an extra amount with an expectation of risk which will be borne by the warship worker. If the goods are loss or damaged, the warship worker should bear all the cost [14]. Ibn Abidin replied that the warship worker should not bear any loses because the worker has no control over such event [14]. Based on Ibn Abidin view, *al-ta'min al-bahri* does not comply to Shariah point of view due to the involvement of *gharar* element and the other reason is risk should not be a subject for trading as well as profit-making as the risk is uncertain in nature.

The parties involved in *al-ta'min al-tijari* are uncertain on the ultimate outcome of contract such as date of delivery, amount of premium to be paid and amount of compensation during the contract is sealed. The Shariah only permits risk to be shared (*al-ta'min al-ta'awuni*) among individuals in the society [5]. According to Shubir *al-ta'min al-ta'awuni* is an agreement among the participants to assist each other in the event of calamity or tragedy with no profitable intention [20]. The management of the fund will be given to the professional body (takaful company) as a trustee of the fund. On the other hand, *al-ta'min al-tijari,* is an agreement between the participant and the insurance company on managing the risk in the event of tragedy [2]. The insurance company considers risk as a tradable product, and the compensation is about loss to the company, the more payment to be made, the more loss will be incurred by the company. Based on the above discussion, the concept of risk mitigation of MRTA must only be applied through the concept of *al-ta'min al-ta'awuni* in risk management for property and long term financing in IFI.

Regarding the risk transfer, al-Masri stated that risk transfer is about the customer's responsibility to manage their own risk, in order to avoid bad consequences [3]. For example, A is the owner of a car which involves in an accident. A must take full responsibility to manage the risk, however, A has transferred to the third party, where the insurance company accepts premium insured from A and promises to pay him back in a case of accidence. al-Masri said that this type of transaction is called *al-ta'min al-tijari* and non-compliance to the Shariah, except for the transference in the form of mutual assistance and cooperation (*al-ta'min al-ta'awuni*) [3]. The majority of contemporary *fuqaha* opined that the validity of risk transfer contract is only considered when it performed with *al-ta'min al-ta'awuni* concept and strictly not in a form of *al-ta'min al-tijari* [7]. Shariah does not accept any form of commercialization on risk, since it is non-tradable product and uncertain in nature. Based on the discussion above, the *fuqaha* have no objection to the practice of risk transfer of MRTA as far as it is applied based on *al-ta'min al-ta'awuni* concept. In conventional practice, the customer will bear the risk premium cost. This is an innovation in modern risk management especially in property financing, whereas in the previous system, the funder has to take full responsibility in the case of loss or failure in repayment of loan. Shariah recognizes this practice based on the *hadith* on the obligation of the loaner in any conditions they are; in including by getting assistance from other parties. As stated in a *hadith* compiled by al-Bukhari *hadith* no. 2127;

> *Narrated Salama bin Al-Akwa while we were sitting in the company of Prophet, a dead man was brought. The Prophet was requested to lead the funeral prayer for the deceased. He said, "Is he in debt?" The people replied in the negative. He said, "Has he left any wealth?" They said, "No." So, he led his funeral prayer. Another dead man was brought and the people said, "O Allah's Apostle! Lead his funeral prayer." The Prophet said, "Is he in debt?" They said, "Yes." He said, "Has he left any wealth?" They said, "Three Dinars." So, he led the prayer. Then a third dead man was brought and the people said (to the Prophet), Please lead his funeral*

> *prayer." He said, "Has he left any wealth?" They said, "No." He asked, "Is he in debt?" They said, ("Yes! He has to pay) three Diners.', He (refused to pray and) said, "Then pray for your (dead) companion." Abu Qatada said, "O Allah's Apostle! Lead his funeral prayer, and I will pay his debt." So, he led the prayer.*

The *hadith* clearly mentions the responsibility in managing a credit risk to the loaner. They must be responsible in whatever condition they are in and ignorance in paying the loan will face a bad consequences in the day of Judgment. As stated in a *hadith* complied by Imam al-Tarmidhi *hadith* no. 998; *Narrated by Abu Hurayrah (r.a) said, the prophet Muhammad did say, the soul of a believer is bound to his debt until he returns it.*

Imam al-San'ani stated that this *hadith* shows the urgency of any individual to clear up his or her debt, no matter what condition he or she is in. In fact, debt settlement aftermath of death is the highest priority [6]. The above *hadith* explain that the family of the dead must put the debt settlement prior to anything else. Prophet Muhammad had shown an example when he sold Muaz's wealth in order to clear Muaz's debt. Imam al-San'ani added that the majority of *fuqaha* agree with the punishment on the ignorant loaner by imprisonment and preventing them from spending [6]. The practice of MRTA through the concept of *ta'min al-ta'awuni* is compliant to Shariah, and the risk premium cost should be borne by the bank's customer as it is his or her responsibility to repay the financing cost.

6. CONCLUSION

This study has come to the conclusion that the management of risk in a form of Mortgage Reducing Term Assurance (MRTA) should only be applicable with the concept of *al-ta'min al-ta'awuni*.The transferring of risk to a third party is allowed in Shariah point of view, as long as the transfer is free from the element of *gharar*. The risk transfer must serve the concept *al-ta'min al-ta'awuni* which is mutual help and assistance among the participants. Shariah also views that the responsibility of bank's customer to pay the risk premium cost, this is due to the fact that repayment of loan or financing is the responsibility of the customer.

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