

Sharī'ah Analysis of Acquisition of House Financing Portfolio: A Case Study of Bank Islami and Citi Bank Pakistan

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Abstract

Purpose - The Objective of this study is to provide a comprehensive scenario of the Acquisition of House Financing transaction taken place between Bank Islami and Citi Bank during 2010 in the light of Sharī'ah guidelines. The purpose of this whole complex transaction was to acquire Citi Banks house financing portfolio. The successful completion of such a transaction is an important milestone for Islamic Banking. The complete understanding of such transactions is of prime importance for Islamic banking academia.

Findings - The study concludes that the transaction based on Hawalah (assignment of debt) and Wakalah Lil Qabz (recovery agency) is very complex and intelligently designed to conduct these transactions.

Policy Implications - This study will enable the policymakers, Sharī'ah Advisors, and bankers to explore new avenues for investment in Islamic Banking Institutions. This study will also enable academicians and research students to conduct research for product development in related areas with conventional banks. The complete understanding of such transactions is of prime importance for the product development department of Islamic Banks.

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Introduction

Islamic Banking is a Shari'ah compliant alternative of conventional Banking system available to all irrespective of their faith and religion. The latter is based on interest which is strictly prohibited in Islam. In Islamic Banking industry, generally participatory, trade-based and rental based modes are used for investment and financing matters. This basic and significant difference in Islamic bank's operations makes inter-bank transactions very difficult when transacting with conventional banks.

On 27th December 2010, Bank Islami acquired Citibank's house financing portfolio amounting to Rs.953 million. This acquisition was a milestone for the Islamic banking industry in Pakistan as this was a first time, an Islamic bank had acquired mortgage assets of a conventional bank. The Citibank's house finance customers were required to switch to the Islamic mode of financing.

The information relating to this case is not available to the general public. However, the understanding of these transactions is of prime importance due to many reasons. First, to ensure that the Islamic banking industry is going into the right directions and in the cover of complexity, nothing un-Islamic is being mixed with Islamic banking. Second, to enhance financial innovation in the Islamic banking industry, the complete understanding of such transaction to Islamic banking academia is also of prime importance. Still, no attempt is taken since 2010 to write anything about explaining this seminal transaction. Therefore, the Objective of this case study is to provide a comprehensive overview of the transaction in light of Shari'ah that how an Islamic Bank makes it possible to buy the assets of a conventional Bank. It is important to mention that data and information regarding this transaction are not available publicly. The information and data presented in this case study have been collected from executive management of the Bank Islami Pakistan (BIPL) and Citi Bank to provide some basic and core information through email against some open-ended questions.

This study will enable the policymakers, Shari'ah Advisors and bankers to explore new avenues for investment in Islamic Banking Institutions. This study will enable academicians and research students to conduct research for product development in related areas with conventional banks. This study will also be useful for the product development department of Islamic Banks.

Islamic Banks and House Financing

Islamic Banking in Pakistan is growing rapidly. This industry has achieved various milestones in recent years. Assets of the Islamic Banking Industry (IBI) recorded growth of Rs. 65 billion and reached to Rs. 1,853 billion compared to Rs. 1,788 billion. Deposits of IBI also increased by Rs. 97 billions and reached Rs. 1,573 billion compared to Rs. 1,476 billion. Market share of Islamic banking assets and deposits in the overall banking industry stood at 11.7 percent and 13.3 percent, respectively which is increasing day by day ([SBP, 2016](#)).

The Islamic House financing facility offered by Islamic Bank Institutions (IBI) in Pakistan is generally based on Diminishing Musharaka (Musharaka Mutanaqisa) ([Shahzad, 2012](#)). This mode of transaction is a combination of three contracts i.e. Sharikah-tul-Milk (Partnership), Ijarahh (Lease) and Bay (Sale) ([Osmani, 2010](#)). The IBI and customer jointly enter into a partnership, on the basis of Sharikah-tul-Milk ([Shahzad & Farooq, 2014](#)). The IBI leases its share to the customer and on the other hand, the customer also purchases IBI's property by units periodically ([Shahzad, 2015](#)). The customer purchases units of IBI until the customer becomes the sole owner of the property ([Usmani, 1998](#)). The customer pays rent to IBI for using a share of IBI. As customer purchases share of the IBI his payable amount of rent decreases until the payable amount of rent becomes zero. This mode of financing is normally used by the IBI(s) in Pakistan for House financing ([SBP, 2016](#)).

Process Flow of Diminishing Musharaka for House Financing

1. Both parties i.e., IBI and customer, contribute their share in joint ownership of the house on the basis of Shirkah-tul-Milk.
2. The IBI leases out its owned portion of the house to the customer.
3. The customer pays rent after the house is purchased and the customer takes possession of the house².
4. The customer pays rent of IBI's owned share and gradually purchases a share of IBI.
5. The customer purchases all units of the house owned by IBI and becomes sole owner of the house.

PROCESS FLOW OF DIMINISHING MUSHARAKAH IN HOME FINANCING:

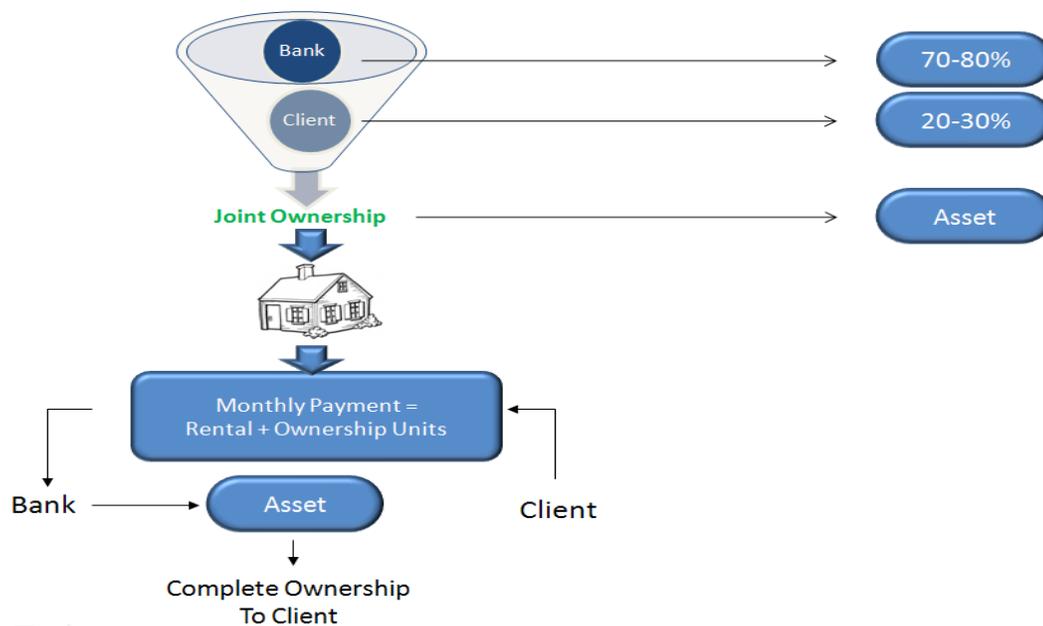


Figure 1 - Process Flow of Diminishing Musharaka in Home Financing

Bank Islami's Muskun House Financing

The Bank Islami offers Muskun house financing on the basis of Diminishing Musharaka and Ijarah. The Bank Islami offers house financing facility up to 50% to 70% of the total value of the property for a maximum tenure of 25 years ([Bank-Islami, 2015](#)).

² As a matter of rule in Islamic law an effect can't be presumed until and unless its cause comes into beings. We can't sale what we don't have in our ownership likewise a thing which is missing an ingredient of ownership is invalid for selling and rent is akin to sale.

Process Flow of MUSKUN House Financing

1. The customer submits a request for house financing to Bank Islami regarding the home purchase, construction, renovation or balance transfer facility through filled application form along with required documents and process fee submitted through cheque.
2. After verification of customer's addresses references, the Bank Islami conducts income estimation of the customer in order to determine the maximum limit of financing that can be provided to the customer. In case the customer is self-employed, the Bank requests for documentation of his income details ([Bank-Islami, 2015](#)). On the other hand, if a customer is a salaried person, the bank approaches the employer of the customer for verification.
3. The bank also obtains a legal opinion on the property documents of the customer.
4. After the determination of market value of the property, the Bank Islami issues an offer letter to the customer for Muskun house financing with approved financing amount.
5. If the customer accepts the terms and conditions of the Bank, both the parties sign an agreement of Shirkat-ul-Milk (Musharaka), whereby, parties become joint owners (partners) in the Musharakah property i.e., house.
6. The Bank Islami issues a Pay Order in the name of the contractor or seller.
7. Both parties execute an agreement of Monthly Payment, through which customer agrees to pay a monthly payment to Bank Islami.
8. An Undertaking to Purchase Units is given by the customer, whereby the customer undertakes to buy the Musharaka Units (Banks property) periodically. The monthly installment includes a monthly rent and monthly unit price ([Shahzad & Farooq, 2014](#)).
9. After purchasing all Musharkah units of Bank Islami's share, the customer becomes the sole owner of the property.

Overview of the Transactions

The objective of Islamic Banks is to provide interest-free banking facilities to its exclusive customers, through Shari'ah compliant products and services. The basic feature of the products of Islamic banks is asset-backed financing. The most frequent transactions of the Islamic banks are Participatory Modes; i.e. Modarbah, Musharkah, Second type is Trading Modes: Bay Moajal, Bay Murabha, Bay Salam, Bay Istisna, and the third type is Rental Based Modes: Diminishing Musharkah, and Ijarah. There are a number of examples of transactions among Islamic Banks but rare cases of dealings with conventional banks because they deal in the interest-based transaction.

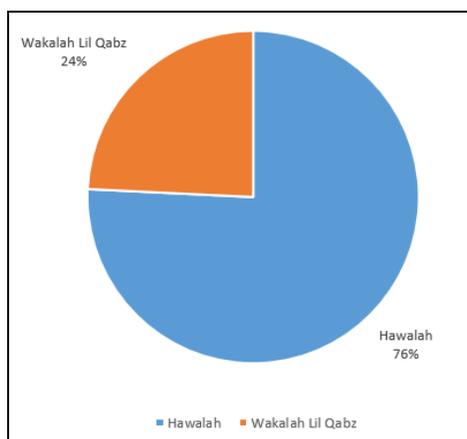


Figure 2 - Transactions Volume

In December 2010, the Bank Islami Pakistan Limited acquires Citibank's house financing portfolio amounting to Rs.953 million. The Citi Bank is a conventional Bank which executes Interest based transactions. On the other hand, Bank Islami is an Islamic Bank which deals in Interest-free transactions. The portfolio of Citi bank has been based on interest regime where the bank lends money to its customer and charge interest income on the invested amount. The purchase of a loan is known as Bay' al-Dayn³ which is prohibited in Shari'ah. Therefore, Bank Islami construct this transaction into two tiers, i.e. Shari'ah Compliant Structure of Hawalah (assignment of debt)⁴ and Wakalah Lil Qabz⁵ (recovery agency). The Bank Islami has settled a loan amount of Rs 722.590 million with Citi Bank, N.A. - Pakistan Branches against the acquired portfolio amounting to Rs 953.273 million (comprising of Rs. 722 million under an assignment of debt and Rs. 231.130 million under Wakalah Lil Qabz). However, about 30 customers out of 369, refused to be switched to the Islamic mode of financing.

Execution of the Transactions

Since the Citi Bank's portfolio is a conventional debt portfolio and purchase of such portfolio is not permitted according to Shari'ah, therefore, Islamic mode of Hawalah, which is an assignment of debt from

³ Bay' al-Dayn is Arabic term which means sale of debt receivables for a specific amount (usually at a discount to its face value) i.e. it may involve the situation where a person has receivables and wants to sell them at a discount to a third party. The third party will replace the original creditor/lender and will be able to claim the face value, with the difference between what he will get and what he has paid constituting his reward/profit. The traditional Muslim jurists (fuqaha) are unanimous on the prohibition of bay' al-dayn at a discount. The overwhelming majority of contemporary Muslim scholars hold the same view

⁴ Hawalah of debt is the transfer of debt from the transferor (Muheel) to the payer (Muhallaihi). The transfer of right, on the other hand, is a replacement of a creditor with another creditor. The transfer of debt different from transfer of right in that in transfer of debt a debtor is replacement by another debtor, whereas in a transfer of right is creditor is replacement by another. (AAOIFI, Shari'ah Standard: 2015)

⁵ Agency is the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation and it is, thus, permissible. Agency is, basically, a non-binding contract for both parties thereto. However, it may sometimes become a binding contract. (AAOIFI, Shari'ah Standard: 2015)

the transferor to the assignee, was recommended⁶ for the acquisition of performing part of the portfolio. However, for the non-performing part of portfolio remunerative Wakalah was recommended which was a fee-based agency for recovery of nonperforming part of the portfolio; the execution of this acquisition consists of the following two parts.

Part I: Contracts used for the transfer of the portfolio from Citibank to BIPL.

Part II: Contracts used for restructuring the house financing between BIPL and its customers.

Transfer of the Portfolio from Citibank to BIPL

The first part of the portfolio: In this transaction, 76% was performing portfolio whereas the assignments for the performing part of the portfolio was completed into following two separate arrangements:

- a. The parties entered into a loan arrangement whereby Bank Islami Pakistan Limited (BIPL) gave a non-remunerative loan to Citi bank. Against this contact, the parties signed a Loan Agreement Figure 3. Upon payment of the loan amount, BIPL became a creditor (Daa'in) of Citibank;

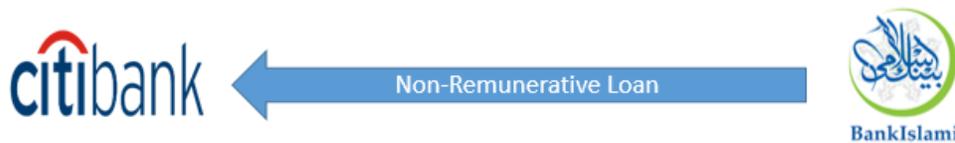


Figure 3 - Loan Agreement between Bank Islami and Citi Bank

- b. The parties entered into another separate arrangement of Hawalah-tul-Dayn assignment of debt whereby Citibank assigned its portfolio to BIPL for recovery against the loan Citi owed to BIPL⁷. Under this arrangement, BIPL acted as Muhaal Alayh (Assignee) and assume the exclusive rights and responsibilities to recover and receive all amounts from the debtors (Customers) of Citi. The loan given by BIPL under Bank Islami Loan Agreement was adjusted against this assignment Figure 4. This assignment was governed under rules for Hawalah under which the assignee (BIPL) had recourse over transferor (Citi)⁸ in cases that undergo a bankruptcy suit in any court of law in Pakistan;

⁶ The acquisition has duly been approved by the State Bank of Pakistan vide letter no. BPRD (R&P-02)/625-93/2010/9690 dated December 06, 2010 and by the Competition Commission of Pakistan vide letter no. 169/CCP/MERGER/2009 dated December 24, 2010.

⁷ This contact of Hawalah was restricted Hawalah, according to AAOIFI [Shari'ah Standard (7) 5/1/2] restricted Hawalah is permissible. It is a transaction where the payer is restricted to settling the amount of the transferred debt from the amount of a financial or tangible asset that belongs to the transferor and is in the possession of the payer.

⁸ The transferee is entitled to have a right of recourse against the transferor in situations of (I) death of the payer in bankruptcy, (II) liquidation of an institution that is the payer in the case of bankruptcy before payment of the debt, (III) the payer is declared bankrupt in his lifetime, or he denies concluding the Hawalah contract and has taken a judicial oath to his effect and there is no evidence to prove otherwise and (IV) the institution that is the payer is declared bankrupt by a court of order. AAOIFI [Shari'ah Standard (7) 7/2]

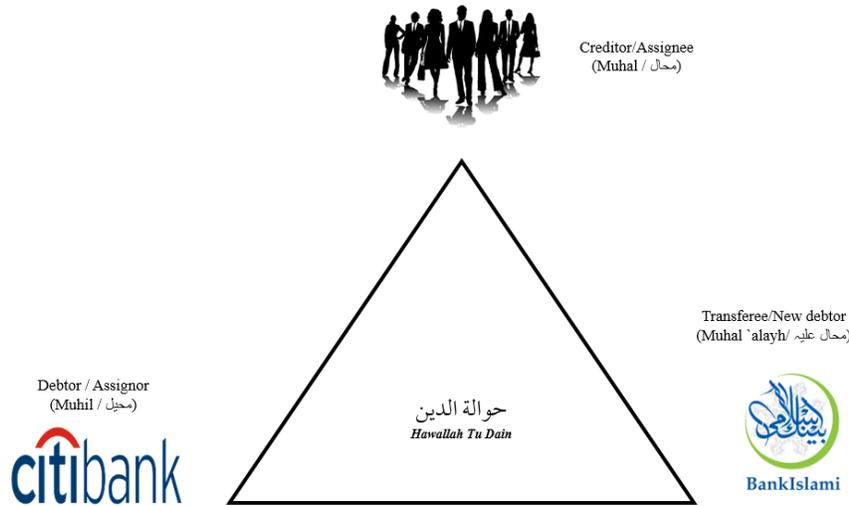


Figure 4 - Hawallah Contract against Non-Performing Loan

The second part of this transaction was an arrangement for the non-performing part of the portfolio which was around 24%. This part of the transaction was completed through the following method:

- c. The parties entered in an arrangement of Wakalah Lil Qabz (Recovery Agency) whereby Citi bank appointed BIPL its agent for the recovery of its non-performing part of the portfolio against payment of a fee and an incentive. For legal reasons, this recovery agreement included some features of legal assignment that allowed BIPL to have right to recover and take possession of the said part of the portfolio;

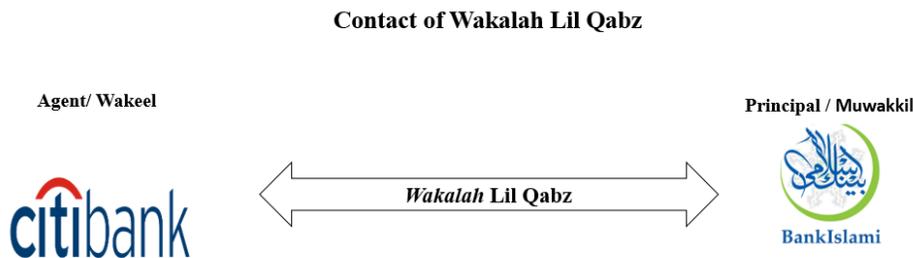


Figure 5 - Contract of Wakalah Lil Qabaz

After the execution of the Assignment Agreement, BIPL had right to receive outstanding amounts from Citi bank’s Housing customers except for any interest or part thereof;

- b. Citi’s Housing customers were approached by BIPL for the signing of the Balance Transfer Facility (BTF) documentation under diminishing musharkah. The customers who refused to sign BTF documents, BIPL requested them to refund the loan amount which the customer owes to BIPL after assignment;
- c. Parties agree that after an agreed date and recovery of any agreed amount Citi bank may give the remaining part of non-portfolio to BIPL as an incentive under Wakalah arrangement;

Contracts Used Between BIPL and its Customers

The second part of this transaction, the BIPL (Transferee/New debtor (Muhāl ‘alayh) entered into an agreement (s) with Creditors / Assignee (Muhāl) on the basis of a Shirkat ul Milk based Diminishing Musharakah. The Nomenclature of Shari’ah compliant Contracts used i.e. Hawalah, Wakalah; and Diminishing Musharakah⁹.

The customers were given the option of paying partial or the full amount they owed in a lump sum to BIPL, without any extra charges. In this transaction, about 90% of the cases had a decrease in financial burden as the customers were given a discount in their rates. About 10% of the customers were brought on the same rate that Citi bank charged them and thus had no effective change in their rates. The rental rate of BIPL was 1-year KIBOR + 3.5%¹⁰ and was less than Citibank’s rate but in case of bad debt afterward, BIPL would be responsible for all transferred cases.

The transaction did not increase any tax burden for the customers. This transaction was recorded on book value by BIPL. The distinguishing characteristic of this transaction was the unique Shari’ah structuring to acquire and re-structure the riba-based portfolio into a Shari’ah compliant portfolio.

Analysis of the Transaction

In December 2010, a transaction took place between Bank Islami Pakistan and Citi bank Pakistan. In this transaction house financing portfolio of Citi bank was acquired by Bank Islami by undergoing various steps and procedure which involve various methods. These methods are claimed to be in their true spirit compliant with the Shari’ah guidelines. A detailed discussion and procedure of the transaction between bank Islami and Citi group are mentioned in this case study. These details will not be repeated in this section.

Below is given a detailed dissection of the procedures (in light of Shari’ah guidelines and procedures) involved in the transaction due to the reasons that Bank Islami is formulated on the grounds of Shari’ah guidelines and Citi group Bank is interest based bank.

According to AAOIFI’s Shari’ah standard, Hawalah can be defined as follows:

“Hawalah of debt is the transfer of debt from the transferor (Muheel) to the payer (Muhāl Alaihi). The transfer of right, on the other hand, is a replacement of a creditor with another creditor. The transfer of debt differs from the transfer of right in that in the transfer of debt a debtor is replaced by another debtor, whereas in a transfer of right a creditor is replaced by another creditor” (AAOIFI, 2015)

The definition explains that Hawalah is a transaction, in which three parties are involved i.e. transferor (Muheel), payer (Muhāl Alaihi) and Creditor. In this contract, the debt to be paid is transferred to another party who is the payer. Secondly while transferring Hawalah to the creditor with another creditor i.e., a person or entity who is supposed to receive a loan from another person, transfers his credit to third person or entity.

⁹ Diminishing Musharakah (Musharakah Mutnaqsa) is the combination of three contracts which are Sharikah (Partnership), Ijarah (Lease) and Bay (Sale). In this contract Islamic financial institution and the customer participate in the joint ownership of a property on the basis of Sharikah tul Milk. The share of the financier is divided into a number of units and the customer purchases those units one by one periodically until he becomes the sole owner of the property. The Customer pays the rent to Islamic financial institution for his part. As the Customer purchase units of the Islamic Financial institution his payable amount of rent decreases, finally the payable amount of rent remains zero. (Shahzad and Farooq: 2014)

¹⁰ This rental rate was standard rate of BIPL for its house financing customers during this transaction.

Bank Islami transacted Hawalah with Citi Bank by following the first portion of the definition mentioned above and it is because the Bank Islami already lent Rs. 953 million as a loan to Citi Bank¹¹ and then entered into an agreement of Hawalah. But in our viewpoint, Bank Islami could have done Hawalah agreement with Citi Bank without giving them the loan at first and that could be done by following the second portion of the definition.

There looks to be another justification for provision of loan to the Citi Bank by Bank Islami and then executed the Hawalah process and that is; the conditions of Hawalah mentioned in Shari'ah standard which states:

"The permissibility of a Hawalah requires that the transferor be a debtor to the transferee. A transaction in which non-debtor transfers another is an agency contract for the collection of debt and not a transfer of debt." (AAOIFI, 2015)

The reason for giving a loan to the Citi bank by Bank Islami at first and then executed the process of Hawalah is mentioned above. But consider this the case, there arises another problem or question mark to the process of Bank Islami and Citi Bank transaction and that is; the total value of the house financing portfolio was declared Rs. 953 million and the same amount of loan was given by the Bank Islami but the amount which was transferred to Bank Islami by Citi Bank via Hawalah transaction was Rs. 722.590 million and rest of the amount Rs. 231.130 million was supposed to be transferred to Bank Islami through Wakalah-lil-Qabz (agency agreement). This process is also justified from the Shari'ah Standard "Hawalah" which states:

"... However, the transferor may transfer a lesser amount of a debt owed to the transferee to be settled from a larger amount owed by the transferor on condition that the transferee is entitled only to the equivalent amount of his debt." (AAOIFI, 2015)

As Hawalah is not settling all the debt owed by the Citi Bank and rest of the debt should be done with definitive mean. The technique used for settling the rest of the debt is through Wakalah (agency agreement) of nonperforming part of the portfolio. The nonperforming part of the portfolio apparently looks to be that part of the house financing portfolio which is considered to be a bad debt or customers are termed as defaulters. The Bank Islami was supposed to recover that loan through Wakalah agreement.

This process raises few issues too and these are; a portion which is termed as nonperforming part of the portfolio is supposed to be recovered through Wakalah agreement and the fee of the Wakalah process is the amount to be recovered. There is always a doubt in recoveries of the bad debts, so there exists an uncertainty in the recovery of the debt and consequently brings uncertainty in the recovery of the full amount of debt by Bank Islami and also the fee of Wakalah becomes uncertain.

There are few issues which apparently looks ambiguous in the transaction and we are mentioning these here just to raise flags in order to have an elaborate discussion on the issues. The reason for this meticulous activity is not to leave any stone unturned as the transaction is unprecedented in the history of contemporary Islamic finance practices. The issues which raise ambiguities in the transaction are as follows:

The Hawalah transaction is allowed to facilitate payments and recovery as mentioned in Hawalah standard:

"Hawalah is a legitimate and an independent contract made out of courtesy and is not a contract of sale. It is permitted in order to facilitate payments and recovery."(AAOIFI, 2015)

¹¹ The Bank Islami has lent this amount which is almost equivalent to the value of the Citi Bank House financing portfolio.

The transaction of Bank Islami and Citi banks raises the question of whether it is fulfilling the intentions and true spirits of Hawalah as mentioned in AAOIFI standards. Another question to be answered by the Shari'ah scholar in this context is that; is it allowed to involve in Hawalah agreement without the need of settlement and is it necessary that only needy would ask for Hawalah agreement or not?

The value of the Citi bank house financing portfolio was valued at Rs. 953 million including both performing and a non-performing portion of the portfolio. A question which is not answered in any published report and proceeding of the transaction between Bank Islami and Citi bank according to our knowledge and the question is; what is the procedure of evaluating the value of the house financing portfolio of Citi banks? Is it the values by Citi bank and if yes, then did Citi bank take into account all the receivables (principal amount of mortgage loan by Citi bank to the customers and interest payment to be received on the principal amount) in valuing the portfolio? If the answer to this question is also yes, then another question arises and that states; what would be the status of the Hawalah of that amount which intrinsically accounts interest payments? These issues should be clarified in order to clear out the ambiguities as no published report and proceeding and neither the annual financial statement of the year 2010 of Bank Islami covers any detail regarding these questions.

AAOIFI Shari'ah standard states that:

"The permissibility of Hawalah requires the consent of all parties, namely, the transferor, the transferee, and the payer." (AAOIFI, 2015)

And:

"It is a condition that all Hawalah parties be legally competent to act independently" (AAOIFI, 2015)

The above mentioned two points from AAOIFI Shari'ah standards elaborates the privileges given by the Hawalah agreement to the three parties involved in it. In our case, the three parties are Bank Islami, Citi Bank, and the customers. The question which can be raised that; did every stakeholder of the transaction get equal opportunity and right to express their view and consent in involving this transaction?

It is to mention again in order to emphasize the matter that it is very necessary and to some extent inevitable to answer these raised issues in order to make this unprecedented transaction unambiguous so that it acts as a beacon of light for such sort of future transactions.

Conclusion and Recommendations

The acquisition of house financing portfolio of Citi bank by Bank Islami is an unprecedented activity in the history of Islamic finance contemporary practices. The activity was completed by using the methods of Hawalah and Wakalah. After the acquisition of the portfolio, the Bank Islami contracted a Diminishing Musharkah agreement with the customers acquired from Citi Bank. This whole procedure seems to be remarkably executed and it could open new avenues for Islamic financial institutions.

The execution of the whole activity through Hawalah and Wakalah raises various issues too. These issues are mentioned above in very thorough detail. In the last section of the study, we have elaborated the issues and technical problems which should be answered in order to remove all the possible glitches. The activity was unprecedented and so in order to examine the validity or legality of the processes involved in the transaction, a benchmark was set. The benchmark, in this case, was AAOIFI Shari'ah standards. It is not the domain of this research study to mention the significance and authenticity of the AAOIFI Shari'ah standards but it is

necessary to mention that the board members of the AAOIFI Shari'ah standards are highly qualified and pioneers of Islamic banking practices around the globe.

Another justification of authenticity of the AAOIFI Shari'ah standards is that each and every statement mentioned in the text of the standards is endorsed by Quranic verses or Hadith (Prophet Muhammad sayings) or Islamic jurisprudence maxims. So for these reasons, it was decided to take this text as a benchmark for the evaluation of activities of the transaction under study.

It is seen that the whole transaction involved multiple steps and each step is very rigorously justified but still, a few issues and glitches remained. These issues are thoroughly mentioned in the previous section of this research study. There are various issues and activities in the whole process which are not endorsed by the AAOIFI Shari'ah standards. There is a possibility that these issues showed up due to the reason that the whole transaction is not thoroughly mentioned in any published journal or annual financial statements of the banks.

It is recommended to arrange seminars and discussion forums of Islamic finance experts and academia to brainstorm on the issues and questions raised in this research study and extract a strong viewpoint which would lay the foundation for the future transactions of such sort.

Declaration

This case study was initially prepared and presented in the 3rd Global Forum on Islamic Economics Finance and Banking 2018 organized by Institute of Islamic Banking, University of Management and Technology Lahore, Pakistan.

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