

# **Declining Partnership in Islamic banking: A Jurisprudential-Economic analysis**

by

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## **Abstract**

This paper tries to discuss the Jurisprudential and Economic possibility of using Declining Partnership, as a new financial instrument, in the context of Islamic banking. The results, derived based on an analytical-explorative approach, show that this instrument is Shariah-compliant and in addition, it is economically suitable for Islamic banks; especially when it is compared with others similar Islamic finance instruments like Ijarah Muntahia Bittamlak (leasing) and installment sale (hire purchase). The findings of this paper may contribute to the available literature in the field of Islamic banking and can help Islamic banks in country-wide Islamic banking systems (like Iran) and even dual banking systems (like Malaysia) to strengthen their banking activities with Islamic instruments.

**Keywords:** Declining partnership, Islamic banking, Islamic jurisprudence, financial system, Operational Models

## **1. Introduction**

One of the main problems in the real part of economy is the insufficiency of small and dispersed capitals of people in performing necessary investments. An ideal financial system is one which can design sufficient instruments so that those who have the capability for investment but does not have the necessary capital can collect the small capital of people by using these instruments. Since in the conventional banking systems interest is legitimate and popular, a main portion of this problem has been solved through using interest-based financial instruments like bonds and loans.

However, Since in the Islamic context, usury and interest (in any forms) are prohibited and economic activities based on Islamic contracts (which give rise to profit) are emphasized, Muslim thinkers, using the Islamic contracts, have tried hard to come up with Shariah-compliant instruments for the Islamic banks

This paper tries to introduce "declining partnership" as a new instrument for Islamic banks and financial institutions. The main question of the paper can be stated this way: "Is it jurisprudentially and economically possible for Islamic banks and financial institutions to make use of declining partnership contract?". The rest of this paper is designed in a way to answer this question. The discussion starts with a review of the available Literature.

## 2. Literature Review

The most important studies done about declining partnership include:

Fazeliyan and Bidgoli (2005) discussed the Islamic Methods of Financing Housing. It has introduced declining partnership as one of the methods of financing for buying houses along with installment sale.

Torabi (2005) has mentioned different kinds and jurisprudential injunctions of the declining partnership. In this article three kinds of declining partnership are introduced and the issue of profit distribution is discussed.

Kamal et al. (2003) considers creating new opportunities, increasing housing construction, distributing the loss between the partners and the owners' achievement of fair profit as the advantages of declining partnership. However, it is believed that while most of the times the intention of partners of any contract is achieved through the continuation of the partnership, in declining partnership they have the intention of leaving partnership from the beginning and this might cause *Ghrrar*. Hence, the findings of this work show that the declining partnership contract is legitimate only if it is not polluted with the doubt of usury and *Ghrrar*(deception).

In spite of the works done, there is a gap for a comprehensive investigation about the jurisprudential and operational dimensions of declining partnership and comparing it with similar contracts and mentioning its advantages. The present article seeks to fulfill this important duty. In this research, in addition to investigating different jurisprudential dimensions and answering the most important doubts of this contract, we deal with designing a practical model of declining partnership for Islamic banks.

## 3. Definition of Declining Partnership

Two real or legal persons with a shared capital implement or buy a project and in the contract agree that after implementing or buying the project, one of them would have the right to buy his partner's share completely or gradually and through specific payments. He might pay its price from the interests of the same project, as it is possible to pay the price from other properties.

It is clear that declining partnership is a kind of "Property Company". That is to say, a project which is implemented or bought is financed by two partners based on the contract. Therefore, all of the outcomes of contract partnership exist here and the profit is divided according to their agreement. One of the partners can take hold of the shared property and the other has the right to possess his share gradually.

According to these explanations, it can be said that: "Declining partnership is a business contract in which the partners agree that one of them possesses the share of the other gradually".

#### **4. Advantages of Declining Partnership**

Declining partnership has advantages, some of which are common with other contracts and some of them are specific to this contract. These advantages include, but not limited to, the followings:

1. Using declining partnership leads to diversity in financial instruments in a financial system without usury and this in turn results in a better fulfillment of different incentives of the owners of properties. More diverse financial instruments motivate people to use their wealth in productive activities instead of keeping them for speculative purposes like buying land, jewelry and foreign currency and hence distort and destabilize the economy.
2. Declining partnership causes each side to engage in a real economy. In fact, until the last share is not passed, the two partners are considered as actual owners and should supervise the activities.
3. Declining partnership can be used in a vast scope. people can use it in small projects and banks can finance large projects with those entrepreneurs who are capable of activities but do not have sufficient capital.
4. Normally, in declining partnership, the partner who is supposed to be finally the owner by buying the share of the other, takes the responsibility of implementing the project himself. As a result, he considers due care and enough time to increase efficiency and set the ground for productive use of the resources.
5. In declining partnership, it is possible to consider a condition in which the partner which is supposed to be the final owner, receive a partial rebate for early payments and this can increase his incentives to enter in real economic activities.
6. In this contract, the inability of the partner to buy the determined share does not harm the bank since in this case, the share of the bank is kept intact and it can use the profits originated from his share.

#### **5. Comparing declining partnership with Ijarah Muntahia Bittamlik (leasing) and Installment Sale**

When a partner (like a bank) decides to sell its share of property (like a house) in a specific period to a customer, this is possible through three methods which are: Ijarah Muntahia Bittamlik (In which the bank rents its share to the customer for the intended time under the condition that after paying the last rent, the bank passes the title to the customer); Installment sale (In which the bank sells its share to the customer on credit and receives the price in determined installments) and Declining partnership (in which the bank passes its share to the customer through time).

The jurisprudential necessity of leasing and selling contract can be considered as the advantage of the first and second methods. Another advantage is the simplicity of banking operations in leasing and installment sale. However, using declining partnership is more compatible with the motivation of the customer than leasing.

To understand this, one can consider the case of trading a house. In leasing, the house is in the possession of the bank until the end of the installments but in declining partnership, the possession of the house is gradually passed to the customer and this will increase his incentives. By paying each installment, the partner possesses a larger share of the house. The result is that using the first method is more compatible with the incentive of the bank and the third one is more compatible with the motivation of the customer.

Installment sale has priority for the customer over the other two but it is undesirable for the bank since the bank must pass the ownership of the house to the customer at the time of the contract. Despite being undesirable, this involves taking collateral which slows bank operations; in addition to the fact that the bank faces the risk of liquidity. Another important point is the fact that many customers have problem in giving collaterals to the bank.

In contrast, declining partnership is desirable for the bank since until the last payment the customer has ownership over the project equal to the debts and the title of the project is for the bank. Every time the customer denies paying the remaining installments, the bank can easily demand its total rights. Therefore, in declining partnership there is no need to give collaterals.

To sum up, it can be said that declining partnership is compatible with the motivation of customers and is desirable for the bank. The rationale behind this is that the customers know that finally they will be the owner of the projects and bank is sure that it would gain profit by maintaining its ownership share.

## 6. Jurisprudential nature of declining partnership

Although there are various opinions on the jurisprudential nature of declining partnership, the reality is that this contract is a partnership contract in which a condition is inserted. Hence the contract itself and the condition are both Shariah-compatible.

This contract is compatible with the desired goals and external reality. Therefore, it is necessary to pay attention to the kind of contract terms of conditions. These conditions can be divided into: conditions about **description**, conditions about **performance** of an act and finally conditions of **collateral** events.

The first kind is out of the present discussion. Condition about the performance in declining partnership means that a partner promises to gradually and by certain installments pass the ownership to his partner after the project is finished. So, it is necessary that both parties have the intention of ownership at the time of contract.

In condition of collateral events, one of the partners agrees to pay certain amounts of money over specific periods of time on the condition that its ownership would automatically pass to him after the preparation of the project. Condition about the performance is approved by all jurists and it is obligatory for the one who promises to fulfill his promise and he can be forced to do so like other kinds of law (Bojnourdi, 1974: 266).

Therefore, designing this form of declining partnership would be jurisprudentially correct, but there are disagreements on condition of collateral events. According to some Imamiah jurists, this form is also acceptable and corrects (MohagheghEsfahani, 1999: 4; Mousavikhoei, 1988: 347).

If we consider the condition of collateral events as correct, which is possible from the author's point of view, it has priority over the condition about performance since there is no need for a new contract. In fact, as soon as the partner fulfills his promise (by paying each installment), he would own the proportional share; whereas the condition about performance requires that the partner to pass the ownership to him after repaying each installment.

## 7. Challenges facing declining partnership

There are some drawbacks mentioned about declining partnership which need to be dealt with. These include:

### 7.1. The inclusion of two sales in one

One of the important criticisms on declining partnership is that it is an instance of two sales in one which the Holy Prophet (PBUH) has prohibited\* (Ibn Hanbal, 1984: 175; Termezi, 1983: 350). Sunni Fiqh scholars consider this hadith as authentic and act accordingly. This narration is also mentioned in Shiite Fiqh books. For example, Imam Sadiq (PBUH) says: "The Prophet (PBUH) prohibited short selling and sale and two sales in one and selling what is not available to you" (HorrAmeli, 1986, V. 18: 230).

In interpreting this Hadith, Sheikh Tusi (one of the top Shiite Fiqh scholars) has said: "If a person tells someone that I would sell a good for one thousand units of money on the condition that you buy another good for five hundred units of money, this transaction is null since two sales in one has occurred. In reality, the person does not want to sell his good to that person unless he sells his own good for five hundred units of money. For the other party to have the incentive to accept, the price should be lowered. On the other hand, since this is only a promise, it is not obligatory to be followed. As such, the seller would be satisfied if the price gets real and the buyer must pay the extra price to him which is not determined; so the transaction is null and void" (Tusi, 1982, V. 3: 217).

There are other Fiqh interpretations regarding the issue of including two sales in one. But the important point here is that declining partnership is not sale but partnership contract with some conditions. Hence, the Hadith mentioned above does not include it. In addition, one of the general principles of Islamic finance is that partner are quite free to consider any condition in their financial relations unless it is explicitly prohibited by Shariah. But the conditions in the declining partnership are not prohibited in Shariah.

### 7.2. The Usury (Riba)

The challenge is that when the bank signs a contract with a customer in the form of declining partnership, neither the bank nor the customer has the intention of real partnership. The reason is

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\* «نهى رسول الله (ص) عن بيعين في بيع».

simply the title itself "declining partnership". What comes to mind by hearing this title is that the bank intends from the very beginning to leave the project after satisfying the consumer financial needs and this contradicts the original intention of partnership contract. The main intention of partnership contract is gaining profit by participation of both partners and this cannot be accomplished unless the partnership persists. The result is that this contract is a pretext for escaping usury.

To answer this doubt, another look at declining partnership is necessary. Bank, as an economic entity, tries to gain profit and to do so, performs different activities. In declining partnership, the bank cooperates in implementing the project with the customer. An economic project usually entails added value. If the bank assesses the implementation of the project with the other party as appropriate, it is logical for it to take action. Since usually maintaining and managing the project is difficult after it is finished and is not compatible with the aims and duties of banks, it is appropriate to transfer the ownership to other side of the contract.

On the contrary, the incentive of the customer is to compensate his insufficient financial ability to implement the project and to manage it after it is finished. Declining partnership is a contract that is compatible with the incentive of both parties. Therefore, both parties really intend to cooperate and it's not a matter of mere pretense.

On the course of implementing the project or even after it is finished (until the ownership is transformed to the customer), both parties are responsible based on their shares. Because of the, declining partnership can be considered as a real economic activity and not a tool to prevent usury.

### **7.3. Reluctance**

It may be said that declining partnership is a contract with reluctance. For example, when a land owner goes to a bank and the bank cooperates with him in building a house in the form of declining partnership, the bank keeps the owner's land as mortgage until the last installment is paid; which is against the owner's wish. Cooperation of the bank in the construction is another thing which is imposed by the bank to the customer. So this contract may bring some kinds of reluctance to the owner.

The answer to this doubt is clear. Nobody forces the land owner to sign such a contract with the bank. He does so by his own free will and decision. In other words, if he doesn't enter in the partnership contract with the bank, his land would remain useless; but with declining partnership, he would benefit from its advantages. Along the period that the project is being implemented, both parties cooperate in managing the project and its ownership and none of them can deprive the other from this right. So, there is not any reluctance.

## **8. Banking applications of declining partnership**

Declining partnership can have many usages. A main portion of these applications can be in the banking system. Two kinds of these applications are discussed below:

## **8.1. Financing projects**

A person who has the intention of an economic activity but does not have the sufficient cash capital goes to the bank and asks services in the form of "declining partnership". The bank takes into consideration all technical, economic and profitability dimensions of the intended activity and then finances the financial insufficiency of the investor. In the contract a condition might be set in which the person repays the original capital of the bank along with the expected profit in certain due times and proportionate to the revenues earned from the project. Therefore, the share of the bank gradually decreases and at the end of the project the bank gains all of its original capital alongside with the profit and the investor becomes the owner of the plan.

## **8.2. Financing housing**

Declining partnership can be used for buying or building houses; in a way that the customer and the bank jointly buy or build the intended house and then the bank gradually transfers his share to the customer. Therefore, the bank's share gradually decreases and the customer's share gradually increases and at the end, the customer becomes the owner of the house.

## **9. Operational models of declining partnership**

Different operational models can be suggested for implementation of the declining partnership. Three of them are discussed below:

### **9. 1. The model of combining partnership, leasing and sale**

This operational model for declining partnership can work in this way. First, the customer signs a contract with the bank and they go for buying a specified property together. At the second stage, the bank rents his share of property to the customer. For example, the customer pays 20 percent of the cost of the property and bank pays the 80 percent remaining cost. At the third step, the customer pays the 80 percent share of the bank periodically until the property is completely possessed by the customer.

The financial amounts of rent between the customer and the bank are divided by the partnership shares of them in various times. The proportion of the customer's share increases after each payment of rent. Accordingly, the process of declining partnership is designed as follows:

1. The customer chooses the intended house and presents it to the bank;
2. The bank confirms the customer, seller and the house;
3. The bank and the customer jointly buy the house and the ownership is divided between them according to their shares;
4. The customer rents the bank's share in the house and in return, pays installments monthly;
5. Some part of the payment is the rent for using the benefits of the house and some other is used for buying it;
6. The rent is determined fairly according to the rent of similar houses in real economy. The extra amount which is paid by the customer to the bank gradually decreases the ownership of the bank and accordingly increases the ownership share of the customer (Fazelian and Eslamibidgoli, 2005: 90).

7. At the end of the period of payments, the ownership of the house transfers to the customer.

## **9. 2. The model of combining partnership and the condition of ownership**

Although the previous model is compatible with jurisprudential criteria, calculating the rent and the monetary value of each share, as was mentioned, makes banking operations complex. Considering this, a simpler model can be presented. This model can be presented in this way that after financing the house jointly by the customer and the bank, the bank, based on the condition at the time of the partnership contract, transfers his share to the customer on certain installments.

Since this is done through time, the price can be more than the price of one time transfer. As such, there is no need to calculate separate rents. Like what banks do in the normal leasing contracts where they include the total price of the house, regarding the length of the period of the contract, in the rent. Hence, the rent is distributed according to the price of the partnership shares.

This model, in addition to compatibility with the bank's incentives because of maintaining ownership until the end of the period, is also compatible with the customer's motivations. Moreover, the procedures for conducting this model are also very simple. The stages of this operational model would be as follows:

1. The customer chooses the house or the commodity and presents it to the bank;
2. The bank confirms the customer, the seller and the house;
3. The bank and the customer jointly buy the house and the ownership is transferred proportionally;
4. The bank sets a price for his share and transfers it in the form of equal installments to the customer;
5. By paying each installment, the bank's share decreases and that of customer increases;
6. According to their agreement, the customer uses the bought house until the end of the period;
7. At the end, customer becomes the sole owner of the house.

It should be noted here that this operational model has some advantage in comparison with the first model. The first merit of this model is simplicity which happens as a result of omitting the rent (in fact better consideration of the rent in relation to the price). The second merit is that unlike the first model where sale contract is used, here "transfer in return of certain monetary amounts" or in other words "ownership in return of certain monetary amounts" are considered as a condition at the time of the partnership contract. In this case, it is not necessary to follow the conditions of sale contract.

## **9.3. The model of declining partnership for building property**

This model can be mostly used in building projects. In fact, Industrial and service projects can be designed based on the declining partnership contract. Although the operational model for various projects might be different, but their common aspect can be presented as follows:

1. The customer presents his request for building the intended project to the bank;
2. The bank sends his experts to investigate different dimensions of the project and evaluate its cost-benefits;



3. After determining the share of each party, the project is implemented and is put into practice. Implementation and usage of the project can be done by either the bank or the customer. It depends on their agreement;
4. Using the index of selling on credit or based on predicting future prices and the length of time, the price of the project and the installments are determined;
5. At the end of the installments, the customer becomes the owner of the project and therefore, the bank transfers the related documents to the customer;
6. For projects which generate profit after they are completed, the benefit is dedicated to the partners in proportion to their capital unless there is a special agreement between them;
7. The amount of the profit of the transferable partnership share can be determined according to the amount of the profit of other contracts;

## 10. Price determination in declining partnership models

One the important issue in the declining partnership models is determination the price. The question is that can the partners of the declining partnership contract determine the installments at the time of the contract or should they leave it to the condition of market (at the time when they are due)? Some scholars consider determining the price as a means of usury and believe that in this case, declining partnership contains the trick of usury (Zuheyli, 2003: 495).

The reason is that in the aforementioned hypothesis, one party (like the bank) transfers his share at a price which holds the original capital plus its profit; as if the party has received the interest of his money. The answer to this challenge is that if determining the price entails usury, therefore we must also consider transactions like sale on credit as false and incorrect since the price is precisely determined and divided into installments at the time of the transaction; but it is not the case. So, determining the installments at the time of the contract has no problem if the partners' aim is not the trick of usury. Considering all this, one can come to this conclusion that there is no problem with profit determination in the declining partnership contract.

## 11. Declining partnership Sukuk

In order to use declining partnership in financial markets it is necessary to design appropriate and innovative financial tools. For instance, suppose public or private companies (or municipalities) want to build a project and they have the capability to do so but they do not have the necessary credit and inevitably they must provide some of the costs by themselves and use the rest from the savings of people. They also want to buy the share of the people after building the project in certain time periods and become the sole owner of the project. The time of implementation and completion of the project is evaluated and a specific time for repaying the people's money and the end of partnership is determined.

In these situations, the representative of the aforementioned institutions may go to the financial organization and imparts them the request of publishing the Islamic bonds (Sukuk). The financial institution publishes the Sukuk and sells them to investors and gives the received money to the related institution. The financial institution receives some money as the commission fee from the

institution based on previous agreement. According to the rules of partnership contract, the owners of Sukuk are joint owners of the project in proportion to the nominal value of their Sukuk.

In addition, they possess any increase in the price of the properties of the project and its benefits. In the previous hypothesis, the institution which asks for the Sukuk is the partner of the owners of Sukuk and has the responsibility of implementing the project. The publishers of the Sukuk can pay an amount of money as the profit of the Sukuk to the owners to increase their motivation and at the end of the period, deduce it from the final profit.

One important issue here is the Secondary market of declining partnership Sukuk. Declining partnership Sukuk can be sold or bought in secondary market until they are due. The seller of the Sukuk (who is the owner of the joint share of the project until the selling time) transfers his share to the buyer. The buyer is completely aware of the condition of the contract and by accepting the condition buys the Sukuk. Therefore, just like the original contract in the primary market, the transfer of ownership to others in the secondary market is also correct.

## 12. Conclusion

This paper tried to discuss the Jurisprudential and Economic possibility of using Declining Partnership, as a new financial instrument, in the context of Islamic banking. Based on the above discussions, some important points can be highlighted here:

- All of the contracts which are used in the primary and secondary markets of declining partnership can be Shariah-compliant.
- It is possible to gradually transfer one of the partner's shares to another by including the condition of selling the share of one partner to another at the time of partnership contract. This model is applicable in instances where two partners construct a project jointly and also includes when they buy a ready project. The only difference of these two forms is that in the first one the profit of the project is gradually calculated and paid but in the second one only the price of the project is divided into installments.
- Using declining partnership has merits; the most important ones are: diversity of tools in the financial system without usury, involvement of both parties in a real activity until the last installment, bank's security if the partner defaults, compatibility with the motivation of both the owners of monetary capital and the economic agents.
- Contract term of condition as the condition about performance of an act is correct and compatible with the popular religious decree of jurists but as the condition of collateral events is not in line with a group of jurists' opinion.
- Declining partnership has many usages. For example a bank or a financial institution cooperate with those who cannot afford to buy a house or perform economic projects and then a condition is set in which after buying the house or completing the project jointly, the partner would become the owner by gradually paying certain installments.
- When a condition is made at the time of the contract, it is obligatory to fulfill it and until the contract exists it is obligatory to be loyal to it. Of course, they can nullify the contract and in this case the condition would be nullified as well.
- One of the capabilities of the declining partnership is the possibility of making tools by it. In this case, the owners of declining partnership Sukuk can transfer their conditioned

ownerships to others by selling them. therefore, the secondary market of these Sukuk has no faults.

- It is clear from what was said that new transactions and tools can be designed by including legitimate contract terms of condition and also by combining different kinds of contracts which create diversity and shows the efficiency of the Islamic banking theory in real world.

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