

DIMINISHING PARTNERSHIP AS AN ALTERNATIVE
ISLAMIC HOME FINANCING IN MALAYSIA:
ISSUES AND PERCEPTIONS

by

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LIST OF KEY TERMS

- Al Ghorm bil Ghonm* : Earning profit is legitimized only by risk-sharing and engaging in an economic venture. This provides the rationale and the principle of profit sharing in *Shirkah* profit arrangements.
- Al Kharaj bil Daman* : Has similar meaning: one can claim profit only if one is ready to take liability – to bear the business risk, if any similar.
- Bai Inah* : Selling of something to someone at a higher price (on credit) and then buying it back from him at the same time at a lower price (on cash). This kind of sale and buy-back is prohibited because it effectively means exchanging a given amount of one with a different amount of money, which amount to *riba*. It can be used as deception for *riba* dealing.
- Bai' Bithaman Ajil* : This contract refers to the sale of goods on a deferred payment basis. Equipment or goods requested by the customers are bought by the bank which subsequently sells the goods to the customer at an agreed price including the bank's mark-up (profit). The customer may be allowed to settle the payment by installments within a pre-agreed period, or lump sum. It is similar to a *murabahah* contract, but with payment on a deferred basis.
- Dharuriyat* : State of necessity.
- Gharar* : The root word of *gharar* denotes deception, uncertainty or ambiguity. *Bai' al-gharar* is an exchange in which there is an element of deception either through ignorance of the goods, the price, or through faulty description of the goods.
- Hilah* : A legal trick which is valid in form but invalid in substance. It is used in a transaction to circumvent the basic prohibition.

- Ijarah* : Leasing. A contract under which a bank purchases and leases out asset required by its customers for a rental fee. The duration of the lease and rental fee is agreed in advance. Ownership of the equipment remains in the hands of the bank.
- Iwad* : Recompense or equivalent counter value in an exchange.
- Manfa'ah* : Usufruct (benefit) of the property.
- Maslahah* : Public interest.
- Maqasid al Shariah* : The purpose of *Shariah* which provides the guidance in obtaining wealth by removing hardship (*raf' al-haraj*) and preventing harm (*daf' al-darar*) in the economic sphere.
- Musharakah Mutanaqisah* : A partnership contract between two parties contributing to the capital needed to purchase the asset. The partner that holds the major share leases the asset to the minority partner who will pay monthly rental. Profit is shared based on the rental amount this is used to redeem the equity. The minority partner is allowed to purchase additional share to gain earlier ownership of the asset.
- Murabahah* : A contract of sale between the bank and its customers for the sale of goods at a price which includes a profit margin agreed by both parties. Repayment is made in one lump sum or mutually agrees in installment specified in the contract.
- Ribawi* : Goods which has been defined by *Shariah* that the exchange to be equal for equal. e.g. Gold for gold; silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt. Payment is to be made on equally on the spot.

MUSHARAKAH MUTANAQISAH SEBAGAI SUATU ALTERNATIF KEPADA PEMBIAYAAN PERUMAHAN ISLAM: ISU DAN TANGGAPAN

ABSTRAK

Rumah adalah keperluan asas kepada semua manusia. Kaedah Bai Bithaman Ajil (BBA) atau jualan dengan bayaran tertangguh adalah kaedah yang paling dominan dalam pembiayaan perumahan di Malaysia sejak penubuhan sektor perbankan Islam pada tahun 1983. Dalam urusan ini pihak bank akan membeli rumah tersebut dari pelanggan dan menjualnya kembali kepada pelanggan dengan tambahan untung apabila kemudahan tersebut dibayar balik oleh pelanggan kepada bank. Dengan berbuat demikian, pihak bank sejak dari awal lagi telah mengira keuntungan dari jualan tersebut. Konsep ini serupa dengan pinjaman hutang dibawah sistem konvensional yang sering berkesudahan peminjam menanggung kos yang tinggi dan mengalami masalah ketidak-adilan. Kerana wujud ciri-ciri kontroversi ini dalam BBA, maka dijangkakan ianya akan mendatangkan masalah dalam pelaksanaan. Konsep pembiayaan alternatif yang sedang meningkat naik adalah berdasarkan konsep Musharakah Mutanaqisah (MM). Menerusi konsep ini, pihak bank dan pelanggan bertindak sebagai rakan kongsi dan bersama-sama berkongsi hakmilik keatas rumah yang dibeli. Pelanggan membayar sewa kepada pihak bank dan dalam masa yang sama membeli sedikit demi sedikit pemilikan bank dalam rumah tersebut setiap bulan. Apabila selesai pembayaran rumah tersebut akan berpindah milik sepenuhnya kepada pelanggan.

Objektif utama kajian ini ialah untuk menyelidiki tanggapan dikalangan para pelanggan, pakar-pakar Syariah dan pegawai-pegawai bank mengenai BBA dan MM.

Kajian ini dijalankan dengan menyelidiki enam faktor iaitu penggunaan konsep, kaedah pengiraan dan penetapan harga, pematuhan Shariah, keadilan dan kesamarataan, kesejahteraan masyarakat serta kesaksama-samaan agihan kekayaan dan pilihan pelanggan di antara kedua-dua produk ini. Satu soal-selidik telah dijalankan keatas 300 orang pemilik rumah dan bakal pemilik rumah untuk mengukur tanggapan mereka terhadap ciri-ciri dan operasi kedua-dua produk ini. Analisis seterusnya berpandukan “Theory of Reasoned Action” (TRA) oleh Fishbein dan Ajzen (1975) telah dilakukan untuk menentukan faktor-faktor yang mempengaruhi hasrat pelanggan memilih pembiayaan perumahan MM menerusi “factor analysis, correlation dan multiple regression”. Akhir sekali, pandangan dan pendapat enam pakar Shariah dan enam pegawai bank mengenai kedua-dua produk tersebut diperolehi menerusi proses temuramah.

Penemuan utama kajian ini ialah pelanggan mempunyai tanggapan bahawa pembiayaan rumah MM memenuhi kehendak pelanggan lebih daripada BBA. Hasil dari kajian berdasarkan “Theory of Reasoned Action” (TRA) turut menyokong iaitu hasrat pelanggan menggunakan MM adalah dipengaruhi oleh sikap dan norma subjektif mereka. Pakar-pakar Shariah juga bersetuju bahawa MM adalah lebih adil dan saksama serta mengambil berat tentang kesejahteraan individu dan masyarakat berbanding dengan BBA. Agak memeranjatkan ialah pandangan keseluruhan pegawai bank yang turut menyokong perlaksanaan MM walaupun ada sedikit keraguan tentang harga dan operasi pembiayaan alternatif tersebut. Apapun, perlaksanaan MM adalah satu cabaran yang berkehendakkan perubahan paradigma daripada kebiasaan kaedah pembiayaan hutang kepada pembiayaan berdasarkan konsep ekuiti dimana keuntungan dan risiko dikongsi bersama diantara bank dan pelanggan.

DIMINISHING PARTNERSHIP AS AN ALTERNATIVE ISLAMIC HOME FINANCING IN MALAYSIA: ISSUES AND PERCEPTION

ABSTRACT

Home is a basic necessity for everyone. The *Bai Bithaman Ajil* (BBA) or Deferred Installment Sales facility is the most predominant mode of home financing in Malaysia since the establishment of Islamic banking in 1983. In this transaction, the bank buys the property from the customer and sells it back to him with added profit for payment at a later date. In doing so, the bank capitalizes its profit up front in the sale of the property. The concept is similar to conventional debt financing which often results in high cost and injustice. Given these controversial features of BBA, it is anticipated that there are several issues on its operations. An alternative concept currently emerging is based on Diminishing Partnership (DP). In this concept, the bank and customers are partners and take joint ownership of the property. The customer pays the bank rent and redeems the bank's share on monthly basis until full settlement upon which the house will be transferred from the bank to the customer.

The main objective of this study is to investigate the perceptions of customers, *Shariah* scholars and bankers pertaining to BBA and DP. This is carried out by examining six variables namely usage of concepts, method of computation and pricing, *Shariah* compliant, justice and equality, societal well being and equal distribution of wealth and income and customers' preference between these two products. A survey questionnaire was conducted on 300 owners and potential house

owners to gauge their perceptions of the features and operations of these two products. Further analysis using Theory of Reasoned Action (TRA) by Fishbein and Ajzen (1975) was carried out to determine factors that influence customers' intention to use DP home financing by means of factor analysis, correlation and multiple regressions. Finally, interviews with six *Shariah* scholars and six bankers were conducted to find out their views and opinions between the two products.

The main findings indicated that customers' perceived DP home financing meet their needs better than BBA. The result of the TRA further supported customers' intention to use DP is influenced by their attitude and subjective norm. The *Shariah* scholars also agreed that DP is more just and fair than BBA and caters for the well being of individuals and society. Contrary to expectation, the overall views of the bankers support the implementation of DP, although there are a few reservations on pricing and operations. Nonetheless, the actual implementation of DP is a challenge that requires a paradigm shift from the existing debt financing to equity financing where profit and risk is shared between the bank and customer.

CHAPTER ONE

INTRODUCTION

This chapter provides the background of study and describes issues that arise from debt and equity home financing. It lays out the statement of problem, research objectives and research questions. The motivations of this research are two folds. Firstly, it will investigate the theory and practice of BBA home financing which is alleged to be similar to the conventional debt home financing causing discontent to customers because it is found that BBA is costly, burdensome and attracting criticism from international *Shariah* scholars. Secondly, the study will examine an alternative model known as Diminishing Partnership (DP) home financing which is claimed to be free from the issues faced by the debt financing. The research will also investigate the Theory of Reasoned Action (TRA) (Fishbein & Ajzen, 1975) to determine factors that influence customers' intention for DP home financing. Finally, it will gauge the perceptions of *Shariah* scholars and bankers to further understand the issues pertaining to BBA and DP home financing.

1.1 Background of Study

The growth of Islamic banking and finance in Malaysia is indeed very encouraging. The average annual growth rate is between 18-20 percent per annum (Bank Negara Malaysia, 2007). The central bank of Malaysia, Bank Negara Malaysia (BNM), has set a target of 20 percent for all deposits and financing in the banking industry to be under Islamic banking by 2010. The share of Islamic banking assets in the banking sector as on 31 December 2008 expanded to 17.4 per cent of the total banking assets of the Malaysian financial system as compared to 6.9 per cent in the year

2000. The achievement for deposit as on 31 December 2008 was RM 92 billion and financing RM 108 billion i.e. 18.4 per cent and 19.1 per cent of the total bank deposits and total financing respectively. There has also been a tremendous growth of Islamic banking and finance internationally. The global financial asset was estimated at USD 700 billion in 2007 and is growing rapidly at approximately 15-20 per cent per annum (Mckinsey Report, 2007-2008). The total assets managed by Islamic financial institutions in 2008 was estimated to be between USD400 billion to USD500 billion and the potential market for Islamic financial services was then close to USD4 trillion (Al-Amine, 2008). Prior to exploring deeper into this research it is important to understand the foundation in which Islamic Banking and Finance is based on in order for us to know its objectives and responsibilities. The following four statements can assist us in realizing this purpose:-

Islamic banking is constructed upon the principle of brotherhood and cooperation, which stands for a system of equity sharing, risks sharing and stake taking. It promotes such sharing and cooperation between the provider of funds (investor) and the user of funds (entrepreneur)" (Ahmad, 2000; Iqbal & Molyneux, 2005)

Islamic banking refers to a system that complies with Islamic law also known as *Shariah* law. The underlying principles that govern Islamic banking are mutual risk and profit sharing between parties. The assurance is fairness for all and that transactions are based on an underlying business activity" (<http://www.mifc.com/index>, 2009).

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (*Shariah*) and its practical application through the development of Islamic economics. *Shariah* prohibits the payment of fees for renting of money for specific terms, as well as investing in business that provides goods or services considered contract (http://en.wikipedia.org/wiki/Islamic_banking, 2009).

In relation to “Islamic banking business “,

Bank Negara Malaysia has further defined it to mean banking business whose aims and operations do not involve any element which is not allowed by the Religion of Islam” (Islamic Banking Act, 1983, Act 276, p.6).

As can be seen from the above statements, Islamic banking and finance is governed by certain precepts and principles which must be observed such as prohibition in renting of money, non *riba* (usury) activities, mutual risk, profit sharing between parties and conformity to the tenets of Islam. These religious, ethical and societal considerations do not apply in conventional banking which adopt a capitalist framework with the sole objective of profit maximization. Hence, conventional banks are not bound by religious obligations and free to provide loans to customers using interest rates as its pricing mechanism in its daily business.

The conditions for everlasting well being of the people in Islam governs the way of life for all Muslim – whether in conducting their business affairs or in carrying out their daily activities. Without specifying any situational context, Allah describes people who attain success as those who are “inviting to all that is good (*khayr*), enjoining what is right (*ma'ruf*) and forbidding what is wrong (*munkar*) (Qura'an, *Al Imran*. 3:104). Islamic banking system is established to contribute significantly to the accomplishment of the socio-economic goals of Islam. (Chapra, 1985 & Mirakhor, 2008). Its aim is to promote and develop the practices of Islamic principles, laws and traditions to financial and banking transactions. Another goal of the system is to promote investment companies to be involved in business activities consistent within the *Shariah* guidelines. Islamic banking system also follows ethical principles and aim to eradicate all kinds *zulm* (injustice) which are related to business activities and financial dealings (Siddiqi, 2004). The system is characterized as being community oriented because one of the goals of Islamic financial institutions is to

achieve socio-economic justice (Chapra, 1985). However, paradoxically, many literatures such as (Zaman, 2001), (Iqbal and Molyneux, 2005) have provided evidences that most of the practices of Islamic financial institutions to date are similar to conventional banks as the contracts used are based on fixed percentages of profits similar to fixing interest rate in debt financing. Farooq (2007) in his analysis on the use of profit sharing concept by Islamic financial institutions concluded that these institutions do not utilize the profit and loss sharing mode substantively in the portfolios. His view is also shared by Naqvi (2000) who agreed that although Islamic Banking has moved rapidly, “ it is not being run exclusively on the basis of the *Shariah*-favoured profit and loss sharing (PLS); rather, the fixed-rate type of financial instruments” (p.41). The result of the research by Chong and Liu (2007) further revealed that in practice, only a negligible portion of Islamic banking assets are based on profit and loss sharing and Islamic deposits are not interest-free, but is closely pegged to conventional deposits.

Many scholars like Siddiqi, (1983); Ahmad, (1984) and Siddiqui, (2001) argue that a financial system built dominantly around debt based modes of financing cannot be superior to the existing interest-based system on the basis of equity, efficiency, stability and growth (as cited in Dusuki, 2005). This is because these modes of financing are actually similar to the conventional banking modes and thus cannot remove the injustices of the interest based system. In reference to Chapra (1985), profit making is not the sole objective of Islamic banks as it also has to incorporate social responsibility as well. His view is supported by many other scholars such as Haron (2000), Rosly and Bakar (2003), Siddiqi (2004) and Mirakhori (2008). They are in the opinion that Islamic banks must also have a social responsibility towards the society, protecting them against injustice and promote

Islamic norms and values. Meeting these values are also in line with the purpose of *Shariah (Maqasid al Shariah)* said Yousri Ahmad (2009) citing Al Ghazali (1937).

The philosophy of Islam as way of life (*al-Din*) harmonizes the achievement of *Maqasid al Shariah*. The literal meaning for *al-Din* is religion. One's obligation under *al-Din* is looking after the needs of the family, society and the nature. These responsibilities are all essential for human survival and they become part of *ibadah* (worship) which is carried out by one's intention, action and even thought. The true *ibadah* (worship) for Muslim in all sphere of their lives subscribe to the *Din* of Allah (Quran, *Al- An' am*, 6:162). Al Ghazali (1937) defined the objective of the *Maqasid al Shariah* is to promote the well being of all mankind, which lies in safeguarding five essential elements namely their faith (*din*), their human self (*nafs*), their intellect (*aql*), their posterity (*nasl*) and their wealth (*mal*). Whatever ensures the safeguard of these five essential elements serves public interest (*maslahah*) is desirable. Chapra (2007) has used Al Ghazali's theory of *maslahah* (public interest) which classify the above five essentials to develop a model of human development and well being.

The goals of the *Maqasid al Shariah* entail intense commitment of every individuals and organizations to justice, brotherhood and social wellbeing. This will inevitably lead to a society whereby every member will cooperate with each other and achieve the success in life for ultimate happiness. In the context of Islamic finance, this means the products offer by financial institutions should reflect ethical values, fairness and justice (Yousri Ahamd, 2009). Additionally, Dusuki (2008a) has utilized Al Ghazali's theory of *Maqasid al Shariah* (1937), to measure the extent to which Islamic banking conforms to the purpose of the *Shariah*.

The widespread practice of *Bai Bithaman Ajil* (BBA) began with the introduction of the product by Bank Islam Malaysia Berhad (BIMB) in 1983. This model has been practiced by Islamic financial institutions in Malaysia for the past 27 years. BBA is based on the contract of deferred payment sale (sale of goods on a deferred payment basis) at an agreed selling price, which includes a profit margin agreed upon by the customer and the bank. It is structured as a long term debt obligation whereby price is fixed and benchmarked on market interest rate. The overall cost of financing can be higher than conventional financing raising issues on injustice, unfairness, inequality and not caring for societal well being. BBA home financing has been practiced widely in Malaysia, Brunei and Indonesia (known as *Murabahah* financing) and has put customers as well as bankers in jeopardy during volatile economic conditions due to its fixed rate structure. (Junaidi, 2003; Mydin Meera & Abdul Razak, 2005).

During the 1997 Asian financial crisis, for example, when interest rates were soaring up, Islamic banks were unable to react as the pricing used was based on fixed rate causing huge arbitrage opportunities. This prompted the then Malaysian Finance Minister to suggest the possibility of making Islamic financing structures to be based on variable rates so that banks were able to match their assets and liabilities position (Mydin Meera & Abdul Razak, 2005). Accordingly, BBA home financing was forced to change from a fixed rate structure into a 'floating rate' structure similar to conventional loan to manage the liquidity and other risks 'comparable' to conventional banking. In order to manage this risk, Bank Muamalat Malaysia Berhad made a RM 100 million profit rate swap arrangement with Standard Chartered Bank Malaysia Berhad to ease Islamic banks liquidity position which is primarily based on long term fixed rate assets under BBA contracts.

As BBA home financing is the first Islamic financing product introduced in the market, it adopted the debt financing framework similar to conventional home financing whereby profit rate charged to the customer is predetermined upfront. As the use of interest rate is forbidden in Islam, it is replaced by profit rate. The differences however lie in the computation of profit amount between these two products. In the case of BBA, once the profit rate is fixed at say at 10% per annum, it remains fixed for the entire duration of the contract. This does not apply to conventional interest rate home financing which can freely vary its interest rate according to volatility of the economy. Hence, the variation of interest rate makes it more flexible and attractive to customers compared to BBA home financing which remained fixed until the end of the tenor (Rosly, 1999).

BBA home financing is structured as a debt financing facility based on a ‘sale and buy back transaction’ between the customer and the bank. The current practice has raised several issues as the customers are indebted to the bank for a long period at a fixed selling price. Another issue arises when using BBA for financing houses under construction. As there is a possibility of the house not being completed by the developer or even abandoned, the customers are still required to pay the bank as the property is considered “sold” to them even though it is not completed yet (Hanafi & Kasim, 2006). These debt obligation results in injustice and burdensome to customers as they have to rent another house for their family and at the same time pay the bank’s monthly instalments. In view of the foregoing issues, there is thus a need to further investigate the products features and prevailing practice of BBA.

Chapra (2000) and Dusuki and Abozaid (2007) have emphasized the importance of Islamic finance in meeting the goals of *Maqasid al Shariah* by exercising justice and fair play. In the context of marketing and innovation, it

means that Islamic financing products should follow the principle of value maximization where products being developed should take into consideration various aspects of society such as fairness, transparency and equity which can create significant competitive advantages rather than depending solely on profit. (Saeed, Ahmed & Mukhtar, 2001; Al-Salem, 2009).

According to Saleem (2009) there are three categories of protection provided by the *Shariah* for public interest (*maslahah*) to ensure the welfare of the individual and society. They are known as essentials (*dharuriyat*), necessities (*hajyat*) and embellishment (*tashniyat*). *Dharuriyat* are necessary for the establishment of welfare in this world, as well as in the hereafter. This is followed by *hajyat* which are provisions that remove hardship and thereby facilitate life while *tashniyat*, are provisions that bring comfort and beauty to life. *Dharuriyat* is essential which includes basic necessity such as food and house for shelter. Khan and Ghifari (1992) have put *dharuriyat* as fundamental to *hajyat* and *tashniyat*.

Nonetheless, despite the criteria mentioned above many scholars such as El-Gamal (2006) has argued that Islamic finance has to date failed to serve the objectives of the *Shariah* as it is merely replicating the conventional practice by using debt financing contracts without any new innovation introduced. His view is supported by Siddiqi (2006) who agreed that contemporary Islamic finance practices have not given adequate attention towards the achievement of the *Maqasid al Shariah* as the focus is only on credit-based instruments fulfilling the legal requirements and not the goals of the *Shariah*. Chapra (2008a) and (Rosly, 2008) also concur with El-Gamal (2006) that there is currently a lack of innovation in Islamic financing products which merely rely on debt financing structures.

An analysis of the financing provided to the residential sector in Malaysia for the past 10 years (1996-2005) on Table 1.1 indicates that the average market share for BBA Home financing was only 8.1% compared to conventional home financing of 91.9 % as at the end of 2005. There was an increase of 105% in the demand for the product between 1996 to 1997 when interest rates raised to 11% during the 1997 Asian financial crisis which made the product attractive to customers due to its fixed rate. However, when interest rate decreased from 8% per annum to 6.5% per annum between 1998 to 2001, the market share for BBA home financing began to decline as customers preferred conventional home financing due to lower interest rate. Thus, the demand for BBA home financing grew weaker between 2002 to 2005 and managed to gain only 11% of the market share as at the end of 2005 compared to 89% for conventional home financing. The advantage of conventional financing is its flexibility in interest rates compared to the fixed rate financing in BBA which is more expensive in the long run.

Table 1.1
Performance and market share of BBA Home Financing and Conventional Loan (1996-2005) (RM million)

Residential property	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Avg.
BBA Home Financing	985	2,024	2,699	3,841	3,974	6,846	10,763	14,344	15,433	15,974	
Percentage	3%	5%	6%	7%	6%	8%	11%	12%	12%	11%	8.1%
Conventional Financing	27,926	35,871	40,674	47,282	57,799	79,267	89,526	102,131	117,400	133,151	
Percentage	97%	95%	94%	93%	94%	92%	89%	88%	88%	89%	91.9%
Total Residential property	28,911	37,895	43,373	51,123	61,773	86,113	100,289	116,475	132,833	149,125	
Total percentage	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source for tables 1 BNM Annual Report (1996-2005)

The dependence on market interest rate as a bench mark for BBA has also caused problems in pricing and marketing for BBA home financing (Baharum, 2005). In reference to (Rosly, 1999), when interest rate is low, the amount financed will be more expensive than conventional loan. Thus, customers will shift their financing facility from Islamic banks to conventional home financing. Conversely, when market interest rate is higher than BBA profit rate, Islamic banks suffer losses as the *Shariah* does not permit the profit rate to increase once the selling price is fixed. Hence, there are also issues on the flexibility of BBA home financing. Another issue is pertaining to mismatch of funds due to long term fixed rate in BBA. This happens because deposits from customers are raised via short-term liabilities (between one to five years) while financing granted to BBA home financing are based on longer term duration for example 20 years and above. This mismatch created liquidity problems to Islamic banks which have to bear funding cost risk as it is difficult to accurately compute the cost of funds over long periods due to the volatility of the economic conditions (Bacha, 2004). Conversely, conventional financing has the ability to address mismatch in the cost of funds as it is based on a variable interest rate known as Based Lending Rate (BLR). This argument is supported by Rosly (1999) who agreed that Islamic banks in Malaysia have lesser flexibility on the asset side compared to conventional banks, which can pass on interest rate changes to their customers.

As the pricing for Islamic home financing to date is still based on interest rate, Usmani (2007) emphasized on the need for an alternative benchmark to reflect the true Islamic philosophy. "Islam does not recognize money as a commodity because money does not have intrinsic utility and cannot be utilized directly to fulfil human needs in a real commodity" (Usmani, 2001, p.80). An alternative that can be

considered is the use of rental rate of property as it measures the real value of the house and not money which is pegged to interest rate. The need for an alternative bench mark for Islamic finance had also been emphasized by the Governor of Bank Negara Malaysia (speech, 24 June 2005) “The pricing mechanism for Islamic financial instruments has so far been based on the prevailing interest rate framework. There appears to be no real difference in both the conventional and Islamic instrument” (*www.bnm.gov.my*, 2006, p.1).

The governor further suggested that there is a need for Islamic financial instrument to have its own indicator to be efficiently price. As an example, the use of actual rental rate can be used to determine the rate of return for an Islamic financial instrument that is based on *Ijarah* principle as it gives a true reflection on the price of the property as the underlying asset as opposed to being linked to the Kuala Lumpur Interbank Rate (KLIBOR) which has no correlation with the changes in rental rate.

As can be seen from the foregoing paragraphs, stakeholders such as customers, *Shariah* scholars and banker have raised several issues concerning the existing BBA home financing. Thus, going forward, there is a need to find an alternative mode of home financing that takes into consideration justice, equality, transparency and flexibility which are dimensions of the *Maqasid al Shariah*. Chapra (2008a) further stressed on the need for Islamic banks to be innovative and move away from the debt financing to equity financing. This equity concept used in home financing is known as *Musharakah Mutanaqisah* or Diminishing Partnership (DP).

The DP model is used by successful cooperative-type institutions such as the Islamic Housing Cooperative (Canada), Ansar Cooperative Housing (Canada) and

the Ansar Housing Limited (U.K). The highly successful Islamic Cooperative Housing Corporation (IHC) based in Toronto, Canada was established in 1981 out of necessity to prevent the Muslim community from engaging in *riba* (usury). To join the cooperative, members buy shares in a single equity pool. Once a member accumulates enough shares, the cooperative buys a house his family can live in while paying a proportional rent to the cooperative. Thereon, each member is required to increase their ownership by investing more money in the cooperative's shares until the amount is fully settled and the property is transferred to the member.

There are several differences between Diminishing Partnership (DP) concept and BBA home financing. Firstly, customers are not indebted to the bank at the beginning as it is based on profit sharing. Secondly, the pricing in DP is benchmarked on the actual rental value of property which differ between the types of houses and locations and not pegged on interest rates. Hence, the use of rental rate will avoid *riba* (usury) and injustice. Thirdly, using rental rates provides flexibility in the pricing and not fixed for the entire period of financing as in BBA. Finally, customers can redeem the bank's share earlier to reduce the period of financing. This is not possible under BBA home financing as the profit is capitalized in the selling price. In an interview with the President of IHC, Mr. Prevev, it seems that under the DP concept, some of the cooperative members achieved 100% ownership in seven and half years as the principal amount is reduced when members buy more of the cooperative shares (personal communication, 23, October 2008). In addition to cooperatives, international financial institutions in the United States, United Kingdom, Canada, Middle East, Australia and Pakistan have adopted the DP concept. They are LARIBA Finance House in Pasadena, California, Guidance

Financial Group in Reston, Virginia, TSB Lloyds, Amanah HSBC and Islamic Bank of Britain.

In view of the foregoing evidences, anecdotes there is a need to investigate the perception of customers, *Shariah* scholars and bankers on the differences between the use of debt financing and equity financing in home financing. Firstly, the research will examine the theoretical issues and practices of the existing BBA home financing model that has been implemented for the past 27 years in Malaysia. In the light of the issues raised, it will secondly examine the theoretical issues and practices of an alternative concept known as Diminishing Partnership (DP) which adopts an equity model based on the profit and loss sharing.

1.2 Statement of Problem

Home is basic human necessity for one's family. In Malaysia, the *Bai Bithaman Ajil* (BBA) concept has been the dominant mode of home financing for the past 27 years since the establishment of the first Islamic bank, Bank Islam Malaysia Berhad (BIMB), in 1983. Over the years, several issues have arisen pertaining to the practice of BBA to the extent that critiques have suggested the use of Diminishing Partnership (DP) as an alternative to replace BBA. The main issues that have arisen are related to the usage of concept, method of computation, pricing based on interest rate benchmark, *Shariah* compliant, justice, societal well being and preference for BBA. On the other hand, it is claimed that DP is free from the shortcomings of BBA as mentioned above. Hence, DP is said to be in line with the purpose *Shariah* which promotes risk sharing and its pricing based on rental is considered just and fair. Therefore, there is a need to investigate the perception of customers, *Shariah*

scholars and bankers on the theoretical issues and practices that have arisen with regards to the implementation of these two modes of home financing.

1.3 Research Objectives

1. To examine customers' perceptions on BBA and DP home financing with regards to the usage of concepts, methods of computation and pricing, *Shariah* compliant, justice and equality, societal well being and equitable distribution of wealth and income and preference for the products.
2. To examine factors that influence customers' intention to use DP home financing.
3. To examine *Shariah* scholars' and bankers' perceptions on BBA and DP home financing with regards to the usage of concepts, methods of computation and pricing, *Shariah* compliant, justice and equality, societal well being and equitable distribution of wealth and income and preference for the products.

1.4 Research Questions

The following research questions will be posed to customers, *Shariah* scholars and bankers to gauge their perceptions:-

1. Are there any differences in customers' perceptions between BBA and DP home financing with regards to the usage of concepts, methods of computation and pricing, *Shariah* compliant, justice and equality, societal well being and equitable distribution of wealth and income and preference for the products?

2. What are the factors that influence customers' intention to use DP home financing?. Should DP be introduced, what is the likelihood of its acceptance?
3. Do *Shariah* scholars and bankers have any differences of perceptions between BBA and DP home financing with regards to the usage concepts, methods of computation and pricing, *Shariah* compliant, justice and equality, societal well being and equitable distribution of wealth and income and preference for the product. How do their perceptions affect the likelihood of DP being introduced to the market?

1.5 Research Approach

This thesis uses both quantitative (survey) and qualitative (interview) techniques, to answer the research questions using mixed methodology research approach (Creswell, 2003). The mixed method approach study combines quantitative data collection with qualitative data collection in a single study. The quantitative instrument used in this research is by means of survey questionnaires obtained from customers to uncover and understand customers' perception of the six variables of study and factors that influence their choice for DP home financing. Then, an analysis of personal interviews with the *Shariah* scholars and bankers were made to gain more insights into the quantitative findings. Mixed methodology is used because the combined data can provide a better understanding of the research problem than if either type is used by itself. It has been used in several studies (Abdul Rasid, 2009; Abu Bakar, 2007). This methodology enabled the researcher to achieve systematic and holistic results of the study.

1.6 Scope of Study

The scope of this study gauged the perceptions of three stakeholders namely customers, *Shariah* scholars and bankers with regards to the concepts and salient features of BBA and DP home financing. It is important to initially determine their level of acceptance and issues that arise from the used of these two concepts such as pricing, *Shariah* compliance, justice and societal well being as introducing any positive changes in the market should take into consideration the perceptions of the three stakeholders. The study also investigates factors that influence customers' choice for DP home financing by examining the Theory of Reasoned Action (TRA) (Fishbein & Ajzen, 1975).

1.7 Significance of Research

This study addresses issues faced by customers on debt financing which is the major mode of home financing in Malaysia. As owning a house is a basic need for individual and society, it is essential to conduct a comprehensive study on this topic. Past studies were mainly theoretical and conceptual in nature. The meager empirical studies have mainly used survey questionnaires which is not sufficient to address issues in the problem statement. In this research, the customers' survey probes deeper into the six salient features of the products which include usage of concepts, operations and factors that influence their choice for DP home financing. In addition, the researcher conducted interviews with two significant stakeholders namely *Shariah* scholars and bankers to gain better understanding of the study variables and research problem. It is envisaged that the study will expound the theoretical body of

knowledge on Islamic finance that will benefit the academia and industry. The findings of this study will also provide bankers with useful feed backs in designing their products. In addition, it will also provide guidelines for regulators on policy decisions to further promote the growth of Islamic banking and finance industry in Malaysia.

1.8 Organization of Chapters

This thesis is organized into six chapters. Chapter one begins with the background of study, statement of problem, research objectives, research questions and approach to research. It also highlights the scope and significance of the study followed by the organization of the chapters.

Chapter two starts with an understanding of the Islamic world view of finance. This is followed by the background of the Islamic financial institutions at the international scene and in Malaysia. The last section illustrates the theory of contracts governing conventional and Islamic products in relation to home financing such as *murabahah*, *bai bithaman aji*, and *ijarah and musharakah mutanaqisah*.

Chapter three reviews the literature on the six variables of study namely usage of concepts, methods of computation and pricing, *Shariah* compliant, justice and equality, societal well being and equitable distribution of wealth and income and preference for the products. It begins with the background information on previous studies, research gap and theoretical issues on BBA as well DP home financing practices. This chapter also describes the methodology of conducting the survey, data analysis, findings and summary.

Chapter four begins with the literature review of Theory of Reasoned Action (TRA) and discusses the theoretical framework of Fishbein and Ajzen (1975). It

examines the two unique factors that influence behavioural intention to perform namely attitude towards behaviour and subjective norm. It then relates the application of this theory to determine customers' intention to use DP home financing product using statistical tests namely factor analysis, correlation and multiple regressions.

Chapter five provides the results of the semi structured interviews with *Shariah* scholars and bankers on BBA and DP home financing using the six variables in the customers' perception survey. The purpose of the interview is to provide greater meaning and understanding of the research problem.

Finally, chapter six draws a conclusion to this research by discussing and synthesizing the findings of previous chapters (chapter three, four and five). It will also discuss the major implications and recommendations. It then provides the theoretical, practical and policy contributions. Lastly, it will discuss the limitations and suggestions for future research ending with the conclusion.

CHAPTER TWO

INSTITUTIONAL BACKGROUND

2.1 Introduction

In chapter 1, the study raises an important research problem that over the years while Islamic banking has been successful in offering home financing, several issues have increasingly surface regarding home financing under conventional and BBA modes. In order to assess a broad perspective of the problem and its development, this chapter provides the institutional development of Islamic banking and finance. It is important to understand the historical circumstances that call for the establishment of these Islamic banking and finance institutions particularly in Malaysia. This chapter discusses the Islamic world view and its relations to Islamic finance. Such a discussion is essential to establish a theoretical background and principles of Islamic finance that will provide a benchmark for the evaluation of its activities and practices over the years. This immediate section will discuss the world view of Islamic finance. The second section will discuss the background of the Islamic financial institutions at the international level as well as in Malaysia. The last section describes the theory of contracts governing conventional and Islamic products in relation to home financing such as *murabahah*, *bai bithaman ajil*, and *ijarah and musharakah mutanaqisah*.

2.2 Islamic World View of Finance

The Islamic world view has a broader view of the world. This world includes both visible and invisible. The visible is basically the material world where wealth accumulation is paramount regardless of how it is obtained. On the other hand, the