

A Practical Comparison between Conventional Housing Loans and Islamic Home Financing

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ABSTRACT

The purpose of this study is to compare the dimensions used in conventional housing loans and Islamic home financing from the practitioner's perspective when dealing with Islamic financial debt planning analysis. Embedded mixed method design was used, in which one data set provides support for the other data set. Initially, four documents were reviewed using purposive sampling and the samples underwent content analysis. In addition, qualitative semi-structured interviews with two participants through purposive sampling were conducted to clarify the documents studied. The study reveals that conventional housing loans and Islamic home financing have a great range of interpretation dimensions. Some share common dimensions even though different terms are used. The main findings of the study are that the dimensions that are needed for Islamic financial debt planning analysis are type of financing principles, financial variables, and early settlement clauses. While the results cannot be generalized from the wider samples, the researcher found that the views of practitioners are important in debt planning analysis.

Keywords: Conventional Housing Loan, Dimensions, Islamic Home Financing, Practitioner

INTRODUCTION

Islamic financial planning was introduced in Malaysia as early as 2001 by a group of Shariah advisors and practitioners. The core of Islamic financial planning practice is the planning itself, while the practitioner planner needs to analyse, organize, and implement the financial aspects of the customer. The drawing line of an Islamic financial plan should be implanted with Islamic values and principles that are aligned with Shariah requirements (Sulaiman, 2011). Currently, the four major areas of Islamic financial planning are risk and takaful planning, Shariah investment planning, zakat and tax planning, and Shariah estate planning (Malaysian Financial Planning Council, 2013). Islamic wealth management is related to and essential for Islamic financial planning. However, for comprehensive planning, it should cover Islamic debt planning.

Currently, housing debt is still the largest household debt in Malaysia. Up till 2011, housing debt comprised 45 per cent of total household debt (Rating Agency Malaysia, 2012). In order to tap into this profitable debt financing, Islamic financial institutions (IFIs) introduced Islamic home financing (IHF). In fact, IFH was introduced

in 1983 with the inception of the first IFI in Malaysia. *Bai' Bithaman Ajil* (BBA) financing is perhaps the most popular product used by Malaysian IFIs in providing IHF to the community. However, due to few issues, the topography of IHF has changed into alternative forms of financing such as *Musharakah Mutanaqisah* (MM). No matter what the form of financing, IFIs need to balance out the profit-making activities and the social context (Dusuki & Abdullah, 2007), which need to be aligned with *Maqasid al Shariah*.

With the launch of the Shariah Registered Financial Planner (Shariah RFP) designation by the Malaysian Financial Planning Council (MFPC) in 2008, 267 practitioners qualified for the designation by 2012. However, many of these practitioners were originally practising conventional financial planning, the root of financial planning. The question arises as to whether conventional financial planning practitioners understand the Islamic financial planning dimensions and can provide sound advice on comprehensive Islamic financial planning to their customers. This is because the subject of debt planning is not included in the Shariah RFP programme.

This study compares conventional housing loans (CLs) and IHF from the practitioner's perspective in dealing with Islamic financial debt planning analysis. The study addresses the dimensions of IHF which can contribute to a deep understanding of debt analysis. This study is guided by the main research question 'What are the main dimensions that are essential for Islamic financial debt planning analysis?' Thus, the objective of this study is to compare the dimensions used in CLs and IHF for debt planning analysis. This study will contribute significantly to the relevant authorities, institutions, body of knowledge, and academicians. Eventually, this study is expected to contribute towards producing more effective practitioners who are in harmony with the aspiration of Islamic finance education.

LITERATURE REVIEW

Mortgage Reduction Planning (MRP)

In the Malaysian financial system, Mortgage Reduction Planning (MRP) strategies have been successfully employed for more than 10 years for individuals to acquire homes. The strategies involve restructuring the existing loan arrangement plan using a few techniques. The main technique is an increment of the monthly repayment to repay the principal amount. In CL, there are no issues in the implementation of MRP techniques into debt analysis due to the clarity of interpretation of the legal clauses in CL documents.

Islamic Housing Financing (IHF)

The present study is a further study of Meera and Dzuljastri's (2009) study on comparisons between CL and IHF financing. In their theoretical-practical discussion, Meera and Dzuljastri highlighted the issues faced in IHF financing. With regard to the issue of repayment, they stated the importance of rebate if early settlement is made; however, they did not explain further how this could be done. Thus, the present study discusses the issue of early settlement in IHF from a practical perspective.

BBA is the most popular mode of Islamic financing in Malaysia. Until May 2010, total financing given by Islamic Financial Institutions based on BBA principles remained dominant, constituting 33.0 per cent (Kuwait Finance House, 2010). BBA is a sale contract in which the payment of the price is deferred and payable at

a certain time in the future. It is not a type of sale but it is a mechanism of payment settlement that provides a financing scheme to the buyer to pay on a deferred payment basis, instead of paying the whole amount in one lump sum (Lahsasna, 2010), which is not practical for customers. From the IFI perspective, liquidity management issues arise in the case of BBA with fixed financing. On the other hand, customers face high financing cost with early redemptions (Meera & Dzuljastri, 2009). From the Shariah perspective, the *Bai' al 'inah* issue has been long debated. Due to the various issues in BBA, an alternative form of financing was needed to fulfil market demand.

The alternative, *Musharakah Mutanaqisah (MM)*, is a type of partnership in which ownership is transferred to one party, the customer, as a diminishing partnership whereby a product becomes fully owned by the customer. It is a combination of sale and sharing contracts whereby the ownership is transferred through sale, in which this transfer can be done through a profit sharing arrangement. However, MM housing financing only came into the Malaysian context when Kuwait Finance House introduced it in 2006. Then, RHB Islamic followed with a similar concept in 2007 (Kuwait Finance House, 2010).

The difference between MM and BBA financing can be inferred. While MM financing is a joint ownership of the property, BBA financing is a debt-type financing similar to CL. For the IFI, the profit of BBA fixed profit rate financing is the IFI fixed selling price which cannot be changed but the rent of the property can be revised any time. Thus, a customer opting for BBA financing is obliged to pay the fixed amount in the event of early repayment (Abdul, Othman, Mohd., Arshad, Sahri & Yaakub, 2012). On the other hand, a customer in an MM contract can withdraw from the contract in the middle if he or she gets into difficulties. In BBA financing, the customer owns the house immediately after the contract; however, in MM financing, the customer becomes the full-owner of the house at the end of the tenure. Therefore, MM financing should be a better alternative to BBA home financing due to the feature of flexibility for the customer since they can pay the rentals according to the market price (Meera & Dzuljastri, 2009). In addition, MM financing is globally accepted but BBA financing is only accepted within Southeast Asian countries. The Bank Negara Malaysia

(BNM) Financial Stability and Payment Report (2007) studied the MM financing contract, explained in detail the methodology, the associated risk and risk mitigation if an IFI wished to offer MM financing (BNM, 2011). This further strengthened MM financing as a new type of IHF.

The latest study on IHF from the practical aspects is by Hassan (2011). In his study, he made critical appraisals and analysed the features of IHF from the perspective of the Shariah, ownership transfer and legal documents, profit charged and instalment, and redemption and early settlement. He gave some recommendations regarding calculations that enable IFIs to mitigate the risk. One of the examples is the customer increasing the monthly repayment amount using the time value of money. However, he limited the discussion on full settlement by refinancing. Most past studies limit the discussion to examining the issue of early settlement to full settlement using refinancing.

METHOD AND MATERIALS

This study adopted the embedded mixed method design, a design in which one data set provides a supportive, secondary role in a study based primarily on the other data set. Firstly, a quantitative documents study was adopted for this study. The purpose was to gain clarification of the legal documents. For this purpose, purposive sampling was first conducted to select legal documents from firms endorsed by MFPC and specializing in debt planning. The four documents were obtained from selected conventional and Islamic banks. The selected legal documents for both CL and IHF are discussed below. These documents then went through content analysis.

Second, a semi-structured interview was conducted with two selected participants experienced in debt planning. This was to gain validity and explanation from the documents study finding.

In the documents study, all the four documents were chosen using purposive sampling. They were divided as two CL and two MM financing. All four documents were from local banks. In terms of year topography, all documents taken were from 2013, to reflect current insight. MM financing was recognized by the BNM Shariah Advisory Council (SAC) in 2006. In addition, the

BNM Financial Stability and Payment Systems Report 2007 spells out a comprehensive on the application of MM (BNM, 2007). Thus, the reason for the documents from 2013 used in this study.

In the qualitative study, purposive sampling was adopted. Participants were chosen based on years of experience in the debt planning industry as those in the industry perhaps have the best and clearest understanding of the needs (Tierney & Burleson, 2010). Further, those staff with experience in the area covered in this study (Tierney & Burleson, 2010) also contribute to a better exploration of the dimensions of IHF.

FINDINGS AND DISCUSSION

In the first section (Table 1), the researcher illustrates a practical scenario of housing financing for the amount of RM280,000. Let's take the following example as an illustration. Mr. Ali, the customer, buys a house at the market price of RM350,000. The customer places 20% (RM70,000) as down payment to the vendor. He finances the remaining RM280,000 either through CL or MM financing. For simplicity, let's assume that annual profit rate (APR) is 8% while the financing period is 30 years. A CL will provide a RM280,000 loan to the customer with the aforementioned interest for the period. The difference between this amount and the original RM280,000 is RM459,634.40, which is the profit for an Islamic bank. The profit in CL financing is the interest which is recognized with the lapse of the loan. Using MM financing and assuming the price and the down payment to be the same, we have two portions of the monthly payment, the agreed rental payment and the money to buy back the IFI's shares of the house within the 30 years. In the practical scenario, in order to make the IFI more competitive than a conventional bank, the monthly payment is of the same value as the CL repayment. The distinguishing MRP feature between CL and MM financing is with regard to the balance of financing before the end of the contract. From the calculation, CL uses daily-interest calculation. MM financing which uses profit-leasing portions, also makes the calculation in a manner similar to that done by CL. The purpose is to make it as competitive as CL in the marketplace.

In the next section (Table 2), the researcher discusses the terms and conditions stated in the legal documents.

Table 1: Comparison between CL and MM

	CONVENTIONAL LOAN	MUSHARAKAH MUTANAQISAH
PRICE OF PROPERTY	RM350,000	RM350,000
Down payment to vendor (20%)	RM70,000	RM70,000
Financing amount to customer	RM280,000	RM280,000
Monthly repayment	RM2,054.54	RM2,054.55
Tenure (years)	30	30
Total payment (30 years)	RM739,634.40	RM739,634.40
Bank profit (APR profit rate 8%)	RM459,634.40	RM459,634.40
If terminated after 10 years of repayment:-		
(1) Total payment by customer	RM492,174.12	RM492,174.12
(2) Bank profit (APR profit rate 8%)	RM212,174.12	RM212,174.12

As mentioned earlier, the purpose is to clarify if they align with the theoretical stand-point when there is early settlement. Initially, the researcher conducted a document study by comparing CL and MM financing. Second, the researcher had qualitative semi-structured interviews with practitioners to gain clarification. These findings are based on practical aspects to support the academic discussion.

Findings from Documents Study

In the documents study (Table 3), all the four documents were distributed into two CL and two MM financing. All four financing were from local banks. For more insight, both financing each have one property under a master title and one property under a strata/individual title. The property under the master title is labelled CL 1 and MM 1, while the property with strata/individual title is labelled CL 2 and MM 2.

Before the legal documents, a Letter of Offer is provided to the customer. For CL financing, the legal document is the loan agreement itself for both the property with master title and that with strata/individual title. For MM financing, more documents are required because of the transaction mechanism. In the case of MM financing of the property with master title, the main legal documents comprise the Musharakah Agreement, First/Third Party Deed of Assignment, Purchase Undertaking, Ijarah Agreement, and Service Agency Agreement. On the other hand, MM financing of the property with strata/individual title includes *Musharakah* Agreement, Limited Declaration of Trust, First/Third Party Legal Charge, Purchase Undertaking, *Ijarah* Agreement, and Service Agency Agreement. Since the intention (*niat*) is an extremely important element in Islam, this is stated in the *Musharakah* Agreement. The agreement spells out the purpose of this joint venture, which is to

facilitate the ownership of the property by the customer. However, the joint venture is not deemed to constitute a partnership in accordance with any common law principles relating to partnership. Thus, no party has any binding authority under any common law.

The findings show that the dimensions used by both MM and CL financing are similar. The CL documents state the total loan amount, which is the amount borrowed by the customer. Since the interest is calculated by the reducing balance method, the customer is charged at the balance end. In the current Malaysian context, the calculation is on a daily interest basis. However, this is not the scenario in MM financing, where the total loan amount is termed 'initial financing value'. As stated in the documents, this initial financing value is the margin of financing of the property before adding other sums such as *takaful* contribution.

The interest rate is stated clearly in the CL documents, termed 'base lending rate' (BLR). In Islamic theory, the floating profit rate should be termed 'base financing rate' (BFR). Both MM financing aligned with the Islamic dimensions. Both MM used the term 'Islamic bank rate' (IBR) to replace the term BFR. The profit rate for CL ranged between BLR-1.90% to BLR-2.20%, and for MM financing it ranged between BFR-2.00% and BFR-2.30% respectively. From the customer's point of view, it seems that MM financing offers a rate comparable to that of CL.

Even though not all customers apply risk planning, all the documents clearly show that risk planning terms are used. For CL, the insurance is termed 'mortgage reducing term assurance' (MRTA), while for IFH it is termed 'liability reducing term takaful' (LRTT) or 'mortgage reducing term takaful' (MRTT).

Table 2: Main Legal Documents for MM

DOCUMENTS	EXPLANATION
Letter of Offer	A formal agreement letter by IFI informing the customer of entering into an IHF financing arrangement
<i>Musharakah</i> Agreement	Under the Shariah principle of <i>Musharakah Mutanaqisah</i> , IFI (<i>musharik</i> 1) and customer (<i>musharik</i> 2) agree to enter into a joint venture (<i>Musharakah</i>) for the purpose of facilitating the ownership of the property
First/Third Party Assignment	Customer as beneficial owner assigns absolutely to IFI the assigned property
Purchase Undertaking	Customer wishes to give IFI irrevocable purchase in respect of the <i>Musharakah</i> unit
<i>Ijarah</i> Agreement	Under the Shariah principle of <i>Ijarah</i> , IFI as lessor will lease its respective stake in the property to customer as lessee
Service Agency Agreement	Under the Shariah principle of <i>Wakalah</i> , customer is appointed by IFI as service agent, in which the customer shall assume the responsibility of assisting the bank in carrying out and performing all major maintenance required

Table 3: Comparison between CL and MM Legal Documents

	CL 1	CL 2	MM 1	MM 1
Financing years	June 2013	July 2013	June 2013	July 2013
Loan amount / Initial financing value	RM450,600.00	RM397,605.00	RM 409,074.00	RM385,973.00
Interest rate / <i>Ijarah</i> rate	BLR – 1.90% (daily interest calculation) (BLR = Base lending rate)	BLR – 2.20% (daily interest calculation) (BLR = Base lending rate)	IBR – 2.00% (IBR = Islamic bank rate) Ceiling rate: 10.25% Floor rate: 0.00%	IBR – 2.30% (IBR = Islamic bank rate) Ceiling rate: 10.25% Floor rate: 0.00%
Period (months)	360	300	300	360
Insurance / Takaful	Mortgage Reducing Term Assurance (MRTA)	Mortgage Reducing Term Assurance (MRTA)	Liability Reducing Term Takaful (LRTT)	Mortgage Reducing Term Takaful (MRTT)
Monthly payment	RM2,354	RM2,201.00	RM2,311.00	RM1,923.70
Prepayment clauses	Advance payment	Advance payment with rebate clauses	Advance payment with <i>Ibra'</i> clauses	Advance payment with <i>Ibra'</i> clauses
Main legal documents	Loan Agreement	Loan Agreement	<i>Musharakah</i> Agreement, First/Third Party Deed of Assignment, Purchase Undertaking, <i>Ijarah</i> Agreement, Service Agency Agreement	<i>Musharakah</i> Agreement, Limitation Declaration of Trust, First/Third Party Legal Charge, Purchase Undertaking, <i>Ijarah</i> Agreement, Services Agency Agreement

The period and repayment financing amount are mentioned in detail in the financing documents to avoid uncertainty. All the documents use a single repayment amount. However, a clause mentions that the calculation is based on the floating rate, thus it may vary when the rate changes. In CL, the repayment amount is fixed throughout the period loan. This repayment amount includes repayment for two portions - interest

payment and principal reduction. On the other hand, in MM financing the repayment amount is also for two portions - *Ijarah* rental and price to purchase the IFI's *Musharakah* unit. In practice, the *Musharakah* unit is mentioned in percentage terms for easy purpose.

Early settlement dimensions are much considered by practitioners in the MRP strategy. For CL, the extra

payment is treated as advance payment in the suspense account, even though the calculation should be based on the reducing balance method. This means the extra payment made by the customer will be put in a suspense account. This money is kept until the banks think fit towards the settlement of any liabilities due to the bank. Later, the money is treated as advance payment for the loan. This seems not to be in alignment with the reducing balance method principle. For both MM financing, the guidelines mention the use of rebate (*ibra*) by IFI but do not state how the extra payment in the suspense account is treated. Although the documents do highlight the *ibra* clauses, this is subject to the absolute discretion of the IFI.

Findings from Semi-Structured Interview

Further, this study conducted interviews with practitioners to explain the dimensions. This involved interviews with two top management staff from two financial planning firms, specializing in debt planning and endorsed by MFPC to conduct activities relating to financial planning. Thus, the data from the documents study can further be clarified. The participants are labelled as PAR1 and PAR2.

Why IHF terms and conditions are important for Islamic financial debt planning analysis.

First of all, both participants agreed that understanding the dimensions in the terms and conditions of the legal documents is important for debt planning analysis. In addition, the participants stated that those dimensions are essential in both conventional and Islamic financial planning. With regard to how essential an understanding of the dimensions is, PAR1 gave it a score of 90 per cent. He said that he would recommend his colleagues in the firm to learn those basic dimensions. As for PAR2, he stated that he understood the importance and this was because of his work experience and his company management's inculcation of lifelong learning within the organization.

Secondly, both participants stated that understanding the dimensions in the terms and conditions of the legal documents is important to enhance the performance of the employer and the firm.

PAR2 is quoted as saying:

'As Islamic financial planning is still in its infant stage, and we (firm) are in the services industry, staff should

demonstrate strong technical skills, as they (staff) need to deal with both internal and external parties. Thus, it may enhance the performance of the individual. Subsequently, this will reflect the overall performance of the firm.'

Thirdly, the understanding enables a smooth daily internal job routine.

PAR1 stated that:

"Ways of communicating really influence the daily tasks. Using the same language (of those dimensions) enables employees to communicate effectively and prevent misunderstanding."

Fourthly, as marketing tools, the knowledge acquired is needed to develop and maintain the customer base.

This was highlighted by PAR2, who was looking at this from the marketing point of view. He is quoted as saying:

'Marketing services is not same as marketing products. Customers may turn to competitors when they (customers) are unhappy with the marketer. The worst condition would be when our agent does not understand the key dimensions and is unable to explain these to them (customers).'

What are the dimensions in the IHF terms and conditions that are essential to be understood by a practitioner?

Both participants interviewed stated the following IHF dimensions are essential for a practitioner to understand:

1. Type of financing principles

Both participants agreed that the type of financing structure. Practitioners need to understand PAR1 said that the customer generally does not understand the principles behind the agreement. What is important for them is the fund provided to them to obtain the desired house.

PAR2 said:

"Understanding the financing principles itself enables the agent have a complete idea of the financing itself. Thus, he (agent) can share this with the customer and build confidence (in the debt analysis) between them."

2. Financial variables

Conventional financial variables consist of present value, repayment, tenure, and interest. These are essential in determining the financial analysis.

PAR2 explained:

In our practice, we use the conventional variables such as PV (Present Value), FV (Future Value), PMT (Payment), I (Interest), and N (Number of time periods). Besides the manual calculation, our software has been able to only recognize the (conventional) variables since 10 years ago. An understanding of the Islamic variables will definitely make it easier for agents to work. For example, when we first encountered Islamic financing, our agents were unable to key-in the variables into the system as they did not know which the variables were!

The floating profit rate has been used extensively in IHF in Malaysia since the regulator (BNM) gave IFIs the approval to use this rate instead of a fixed rate. The profit rate enables practitioners to conduct mortgage audit on the facilities after repayment for a time period.

PAR1 stressed:

“(Mortgage) Audit is essential to determine if the repayment aligns with the profit rate. We do encounter cases where the calculation of the IFI was not in alignment with our calculation. When we wrote to the IFI to enquire (on behalf of the client), the IFI admitted it was their (IFI) mistake!”

3. Early settlement and *ibra'* clause

From the practitioner's perspective, early settlement can be done through monthly extra payment using the 'dollar-cost leveraging' concept.

PAR1 explained:

“In theory, the treatment of the extra payment (from the customer) is supposed to reduce the huge amount of the principal as in a conventional loan balance reducing calculation method. However, when we deal with Islamic loans, we have to take into consideration the early settlement clause too. The treatment of the extra (monthly) amounts which may be kept in the suspense account does not profit the customer.”

PAR2 added,

“For example, in a conventional loan, the extra payment is treated as advance payment, which means it is only used to pay future monthly instalments. How does the balance reducing calculation come into this scenario? When we do the mortgage audit (for the customer), it does not show the reduction in the total interest payable to the bank. This is the same with Islamic financing.”

CONCLUSION & IMPLICATIONS

Due to time and situation constraints, researcher found conducting this small scale study still very useful in contributing to an understanding of the important dimensions of IHF, which practitioners need. It appears that all participants interviewed stressed that an understanding of the dimensions is essential to achieve comprehensive debt planning study. In the participants' experience, CL which is in a mature stage is more profitable for the customer. MM financing, which uses profit-leasing portions, seems competitive with CL package. The potential of MM financing as an alternative to CL for new house financing has the competitive edge. The main findings are the dimensions needed for Islamic financial debt planning analysis are: type of financing principles, financial variables, and early settlement clauses. Further studies should concentrate on the calculation of the debt planning and the financing behaviour of the customer as related to financial planning. Finally, caution is warranted in the interpretation of the findings of this study, as the Islamic financial planning learning experience pattern will develop as it matures. ■

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