THE PRINCIPLES OF GHĀRĀR IN BAI BITHAMAN AJIL CONTRACT

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ABSTRACT
One of the popular method of home financing in Islamic banking is Bai Bithaman Ajil. However there are circumstances whereby in this type of contract the probability of ghārār involved is very high especially dealing with the purchase of assets which is not yet in existence. Therefore this paper aims to review what is actually meant by ghārār and how does it affects the enforceability of the Bai Bithaman Ajil contract in the Shariah. It also provides on the reasons why in certain occasion the purchase of assets under BBA contract has resulted to the dominance entry of the principles of ghārār hence making it unenforceable under Shariah.

INTRODUCTION
The most popular method of home financing in Islamic banking nowadays is Al-Bai Bithaman Ajil. The BBA home/house financing facility is an Islamic house financing facility, which is based on the Shariah concept of Bai' Bithaman Ajil. It is a contract of deferred payment sale i.e the sale of goods on deferred payment basis at an agreed selling price, which includes a profit margin agreed by both parties\(^1\). Profit in this context is justified since it is derived from the buying and selling transactions as opposed to interests accruing from the principal lent out. The payment will be paid by the buyer through installments method\(^2\).

The mechanics of the BBA house financing are firstly the customer identifies the assets to be purchased, secondly the bank will determine the requirements of the customer in relation to the financing period and nature of repayment. Then the bank will purchase the assets concerned and the bank subsequently sells the relevant asset/property to the customer at an agreed price which consist of;

- actual cost of the asset to the bank i.e financing amount; bank’s profit margin
- customer is to settle the payment by installment payment throughout the financing period

The difference between BBA and the conventional system of purchasing house is that the BBA financing scheme is not tagged to BLR. Thus the installments will be fixed according to the rates declared upon agreement. The selling price is computed as per the formula;

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\text{Selling price} = (\text{monthly installment} \times \text{number of financing months}) + \text{grace period (if any)} \quad 3
\]

For example\(^4\);

- Financing amount : RM100 000.00
- Profit Rate : 8%

\(^1\) Abdul halim Muhammady, Undang-undang Muamalat dan Aplikasinya kepada Produk-produk Perbankan Islam, Dasar Cetak, Selangor, Malaysia p 221
\(^2\) Fuad al-Omar & Muhammad Al-Haq, Islamic Banking, p17
\(^3\) Monthly installment is computed using the agreed profit rate on a constant rate of return and monthly rest. The grace period profit is charged when the bank is financing property under construction. As such, during the construction period, customer will pay the grace period profit only.
\(^4\) Source; The Star, Malaysia, Contributed by Bank Negara Malaysia.
Financing Period : 20 years
Installment per month : RM 837.00
Selling Price=(RM837.00 x (20 x 12) + 0 = RM200,880.00

Although house and commercial property financing are common examples , cars, machinery or any other assets can also be financed under BBA concept. However there will be no problem and dispute if the asset or the property here is already there or in existence. The issue arises as to what if the asset concerned is the house under construction or to be constructed which is not in existence during the conclusion of the contract.
In fact, in such a contract there is tendency that the asset purchased may not be completed and delivered to the purchaser. If such thing happens this will result to the dominance entry of the principles of ghārār in BBA contract.

Before going further it is best if we can determine first what is actually meant by ghārār. Literally, ghārār implies hazard or risk (khatar or mukhatarah), chance or stake. In Islamic legal terminology, this is the sale of an article of goods which is not present at hand; or sale of an article of goods, the consequence ('aqibah) or outcome of which is not yet known; or a sale involving risk or hazard where one does know whether the commodity will later come out to be or otherwise. The term means that such transactions, which are prohibited in Islam in form, are apparently no different from those prohibited in Islam for deceiving when in reality the nature of the object is not known and therefore risk is involved.

Malik define bay al- ghārār, explicitly as aleatory transaction. Bay al- ghārār, according to him can be defined as a sale of an object which is not present so that the quality being good or bad is not known to the buyer. These are sales where there is an element of chance. Aleatory sales are common in pre-Islamic times. Eventually, the transaction of al- ghārār is reported to have been banned by the Prophet.

Whereas according to Ibn Manzur, ghārār literally means danger whereby according to al-Qurafi in his book ghārār also means khadi’ah that is cheating.

In a contract of sale ghārār often refers to uncertainty and ignorance of one or both of the parties over the substance or attributes of the object of contract or of doubt over its existence at the time of the contract. Muslim jurists have differed widely over the definition of ghārār.

There are various definition and interpretation of ghārār by various prominent muslim scholars, among them are;

1. According to Sarakhsi: ghārār takes place where the consequences (of transaction) remain unknown.
2. According to Ibn hazm: ghārār in sales occurred where the purchaser does not know what he has bought and the seller does not know what he has sold.
3. Ibn Abidin defines ghārār in the following words: ghārār is uncertainty about the existence of the subject-matter of sale.

5 According to Schacht, Arabic mukhatarah was attested by medieval Latin as mohatra.
6 Gharar also means risk, peril and uncertainty. The gharar sale is a kind of sale which involves giving an undertaking which the seller is not certain to fulfil.
7 Some jurists like Qadi Ayad said originally gharar is something that superficially shows what you like but actually you hate it. That is why it is said that al dunya mata’ al ghurar ( the worldly life is mere illusion, manipulated without actual awareness of the property being implicated. Taken from the book Al-Qurafi, al-Furuq, 3 Beirut, Dar al fikr(1973) p266.
8 Sarakhshi, Al-Kassani, Ibn Hazm and Ibn Abidin, all of tem belongs to Hanafi school, as egards to the definitions given by them what Ibn Abidin focused in his definition is suspicion but Sarakhshi and Kassani emphasize more on the uncertainty of the outcome.

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4. Ibn al-Qayyim has described *ghārār* as being the subject matter, the vendor is not in position to hand over to the buyer whether the subject matter exists or not.\(^9\)

5. According to Ibn Rushd, *ghārār* is to be found in contracts of sale when the seller suffers a disadvantage as a result of his ignorance, with regard to price of the article or the indispensable criteria relating to the contract or its object or quality or time of delivery.

6. Sanhuri, an eminent modern jurist is of the view that lack of knowledge about the material terms of contract is the distinct feature of a *ghārār* contract. He says that *ghārār* takes place in the following circumstances:
   a. when it is not known whether the subject matter exists;
   b. if it exists at all, whether it can be handed over to the buyer;
   c. when want of knowledge affects the identification of the genus or species of subject matter;
   d. when it affects its quantum, identity or necessary conditions; and
   e. when it relates to the date of a future performance.

While according to Ibn Taymiyyah he seemed to make a clear cut definition and category of *ghārār* when he said that it is of three types. First, *bai ma’dum* that is a sale of non existing contract, second *bai sinin*, that is the sale of something where the seller can never deliver and third *bai majhul* that is the sale of unknown object. In other words he is saying that *ghārār* is similar to *jahala*.

From these definition we can say that basically *ghārār* revolves around the issue of a contract of uncertain outcome, or *ghārār* that is without the sufficient knowledge of the contract (i.e subject matter etc) and also the element of *jahala*(lack of knowledge) and uncertain end of a contract. In other words *ghārār* thus includes both ignorance over the material attributes of the subject matter and also uncertainty over its availability and existence. Therefore in this context the issue of gharar is very much relevant especially in BBA contract concerning the asset which is yet to exist.

**THE RULE FOR PROHIBITION OF GHAHAR**

In general the Quran explicitly forbids all commercial transactions that involve injustice.\(^10\) The Prophet has clearly forbidden *ghārār* and *jahalah*(lack of knowledge)\(^11\) which in contract is characterized by an unspecified element of quality, quantity or price.

The general principle to avoid al-*ghārār* in transaction can be concluded from the Traditions, as reported to have been laid down by the Prophet; a contract must not be doubtful or uncertain as far as right and obligations of the parties are concerned. The object of legal contract, res in commercio must be precisely determined and terms must be clear and known.\(^12\)

In this case the Prophet is reported to have said: “ Do not sell a thing which is not with you.”\(^13\) The sale of non-existent and undeliverable goods was common in pre-Islamic times.

Concerning this matter, ‘Abd Allah ibn ‘Abbas prohibited the selling of dates on a palm tree before harvesting them. This means that the transaction was not valid., unless the goods were ready to be delivered. Zayd ibn Thabit and Zubayr ibn al-‘Awwam, on the other hand, allowed such transactions. It could be suggested that this second opinion was based on the assumption that the purchaser knew of the existence of the goods and that the vendor would be able to deliver them on the agreed terms and at the agreed time. In this case, the

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\(^9\) Ibn Qayyim,Llam al-Muqin, 1 Beirut, Darul Kutub al-Ilmiyyah, 358
\(^10\) Surah An-Nisa’ 4: 29
\(^11\) Reported by Muslim, Sahih Muslim vol 3 p56
\(^12\) This is generally true of measurable (makil) weighable (Mawzun) or countable (ma’dud) objects which are subject to the prohibition of al-riba (usuary). Therefore, as a collorary from the Traditions of the Prophet, it may be inferred that the vendor must be able to deliver the to be transacted.
\(^13\) Reported by Muslim, Sahih Muslim, vol 3, p. 56
purchaser would be aware of the condition of the goods. In addition, ‘Abd Allah ibn ‘Abbas and ‘Abd Allah ibn ‘Umar demonstrates that the companions were concerned to interpret and explain the general prohibition of such sale made by the Prophet and give their rulings.

It may be also inferred that the commodity must be defined and determined and clearly known to the contracting parties. This rule applies to any commodity which can be weighed and measured. A sold commodity is deemed to be sufficiently known to the two parties if it is in their right and they have inspected it, a commodity which is not there cannot be sold, unless both parties have previously seen it. The purchaser has the right of option to refuse to buy it after inspection.

**THE ISSUE OF GHRARAR IN BBA CONTRACT FOR PURCHASE OF HOUSE (TO BE CONSTRUCTED)**

Generally in BBA contract the contract is concluded at the first stage during the signing of the agreement. In this process the bank will purchase the assets/house and sell it back to the customer at a mark up price (which actually amount to more than two times higher than the actual price). The issue arises here as to what if the asset concerned is not in existence or only will exist in the future or end up as an abandoned house or unable to be completed due to unforeseen circumstances. Does this type of contract not amount to *gharar* when clearly finally it will result to a huge loss to the buyer.

After a careful scrutiny and thorough examination, there are three reasons why BBA contract for a purchase of house (to be constructed) will or can amount to *gharar*. And they are;

1. **This type of contract does not fulfil the requirement of subject matter under Islamic law of contract.**

Muslim jurists have laid down several conditions for subject matter in order to become valid and they are;

1. **The Subject matter must exist**

Islamic law lays down the condition that the subject matter (*mahal ʿaqd*) must actually exist at the time of the conclusion of contract. Therefore if the subject matter is non existent, the contract is void even though it could probably exist thereafter or even if it is established then that it would exist in the future. The wisdom behind the underlying prohibition of the contract in the non existing matter is the fear of *gharar* or risk which may affect the consent which is important element of the contract.

2. **The Subject Matter can be delivered**

It is necessary that the subject matter of the contract should be able to be delivered to the contracting parties. This implies that the subject matter must exist or possibly exist at the time of the conclusion of the contract. This rule is applicable in to the property transactions as well as to gratuitous transactions.

3. **The Subject Matter Can Be Ascertained**

It is important that the subject matter must be ascertained and known by the parties to the extent that the knowledge is sufficient to avoid future disputes. To determine how the ascertainment and the knowledge of the parties can be attained it is important to distinguish between the two situations of whether or not the subject matter is actually present at the meeting of the contracting parties.

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14 Al Kasani, Badai Sanai, vol 5, p 171
15 Al Dardir, al Sharh Saghir, vol 4, p 142
If the subject matter is present at the time of the meeting of the contracting parties the Hanafis and Hanbalis hold that knowledge of the subject matter is attained by pointing out the place where the subject matter is placed even if it is in a hidden place. While Maliki is of the opinion that no valid contract can take place unless the parties have laid eyes on it except when it is impracticable to see the subject matter then it can be attained by description. Whereas Shafie rules that as a general rule the knowledge is attained only by seeing the subject matter whether or not it is actually present at the meeting of the contracting parties.

If the subject matter is not present at the meeting of the parties, knowledge shall be attained by having sufficient description of it in such a way as to dispel all elements of ignorance. If the subject matter is ascertained individually, knowledge is attained by description in such a way which facilitates its precise identification.

In the event where the subject matter is not ascertained individually the Hanafi maintains that it should be determined in a manner which dispels serious ignorance, thus it should, for example, define the genus, species quality and quantity. However immaterial lacking of knowledge does not invalidate the contract because the party has the right of ‘khiyar rukyah’.

Whereas Maliki holds that to view the subject matter is sufficient to be determined by description which defines the genus, type and quantum. Contract based on description is lawful and it is not necessary to allow “khiyar rukyah”. The Malikis allow the contract on the invisible subject matter at the meeting of the parties.

Whereas Hanbalis are of the view that the subject matter is sufficient to be determined by description in a way which defines its exact identification. Prior inspection of the subject matter is sufficient to conclude a contract provided that it is not a kind which normally changes between the inspection date and the date when the contract is concluded.

In BBA contract the monthly installment is computed using the agreed profit rate on a constant rate of return and monthly rest. The grace period profit is charged when the bank is financing property under construction. As such, during the construction period, customer will pay the grace period only. In this case what if the property concerned is unable to be completed due to unforeseen circumstances. Inability of seller to deliver the object of sale to the buyer also forms gharar for example the sale of goods yet to be acquired by the seller. If this case occurs it will amount to non delivery of the asset to the purchaser and this will result to the non compliance of the requirement of subject matter of a contract. Here the result of the contract becomes uncertain. Thus the issue of gharar will come into picture.

2. It is similar to Bay’ Ghaib

In BBA contract if the subject matter here is the house to be constructed this will be similar to Bay’ Al-Ghaib or buying the asset which is not in existence.

According to Hashim Kamali with reference to sale of the unseen or sale of what is not visible (bay’ Ghaib) the schools of law have held different views on the ground basically of their respective perceptions of gharar. Whereas Shafi’e considered gharār in bay’ al-ghaib to be fatal, Imam Malik viewed it to be negligible. Abu

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16 Al Kasani, Badai Sanai, vol 5, p 171
17 Al Hattab, Mawahib al-Jalil, vol 4, p 285
18 Al-Sharbiniy, Mughni al-muhtaj, vol 2 p3
19 Khiiyar Rukyah means a choice given to the purchaser either to continue or not with the contract once he has seen the subject matter of the contract. Al-Kassani, Badai sanai, vol 4 p 175
20 The details on khiyar rukyah has been discussed thoroughly in the previous chapter.
21 Al hattab, Mawahib al-Jalil, vol 4, p289
22 Ibn qudamah, Al-Mughni, vol 4 p220
23 Hashim Kamali, Uncertainty and risk taking (Gharar) in Islamic Law, this is a paper presented at the International Conference on Takaful Insurance, Kuala Lumpur, Hilton, June 2, 1999.

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Hanifah on the other hand held that there was no issue over ghārār as long as the buyer was granted the option of viewing (khiyar ru’yah).

This is somewhat different from the views of Ibn Qayyim and al-Sanhuri when they further categorized the sale of non existent goods into four categories;

Firstly, when the object existed in the essence but came into completion thereafter; secondly, when the object although non existent at the time of the contract was certain to exist in the future; thirdly, when the object was non existent at the time of the contract, but whose existence in the future was uncertain and fourthly, when the object was non existent at the time of the contract and could not be expected to exist in the future.

Of these four types only the last two varieties presented situations in which ghārār was deemed fatal and therefore invalidated the contract. As for the first two they have both concluded that ghārār in them was negligible and the sale in both cases was consequently valid.

The problem is how certain we are that in the BBA contract it will fall into the first two categories when there are a lot of cases in this contract the house purchased are unable to be completed and to be delivered to the purchaser. Therefore in this case the purchaser is burdened with the payment of installments of the asset which is not even existed or completed and this will defeat the purpose of the contract itself.

3. It will result to a huge loss to the purchaser.

Generally, there are several advantages of BBA house financing and they are;

- The total cost of the property purchased is determined at the time of the contract or aqad.
- There is no additional or hidden cost that will change the price of the property purchased.
- The transaction is transparent.
- Customers will know exactly when the financing will end.
- There will be no compounding of arrears and outstanding penalty charges.
- Repayment is not subjected to fluctuation of the BLR.
- Allows better financial planning.

However the advantages above will only be enjoyed by those who purchase a complete house/ other assets which already existed using BBA contract. For the house under construction or to be constructed the result is still gharaar and uncertain.

If the bank is unable to deliver the house to the buyer this will result to the huge loss to the buyer. The payment has to be made yet the asset is not acquired by the purchaser and the property cannot be enjoyed by the buyer. This may result to the huge loss and heavy financial burden to the purchaser.

Generally, the purpose of prohibiting ghārār is to avoid disorder in the society due to frustration or lost of property or heavy burden of debts that will affect the smooth running of the family institutions or relations. This is compatible with the spirit of Islam that chooses to prevent detrimental activities from occurring rather that merely curing them. In principle there is no difference of opinion among Muslim jurists about the prohibition of ghārār. They prohibit ghārār because it affects the subject matter and the price, which can generate unearned profit or an unacceptable huge loss. Hence the motive behind the prohibition of ghārār is avoidance of risk in sale.

24 Ibn Qayyim, I’Lam, vol 3 p237
25 Sanhuri, Masadir Al-Haqq vol 4 p 270
26 Taken from The Star newspaper, Malaysia, contributed by Bank Negara Malaysia.
28 Amin S. Hasan, Islamic Law in the Contemporary World, Royston Ltd. U.K, 1985 p72
CONCLUSION

All in all, the guiding principle for the Islamic banking is the Shariah- a set of rules and laws, guiding economic, social, political and cultural aspects of Islamic societies. While the conventional system focuses primarily on the economic and financial aspects of transactions the Islamic system places equal emphasis on the ethical, moral, social and religious dimension to ensure fairness to both contracting parties and the society as a whole. Undoubtedly prohibiting ghārār is one of the nucleus of the system, therefore in BBA contract the asset here must be clearly identified and must be in existence. For the purchase of house to be constructed there should be other alternative Islamic banking product introduced such as musharaka mutanaqisa or other method of financing which can further reduce and eliminate the principle ghārār in the contract.

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CHOOSING AN ISLAMIC MORTGAGE PROVIDER: EMPIRICAL INVESTIGATION AMONG SABAHAN BANK CUSTOMERS

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ABSTRACT
The primary objective of this study is to rank choice criteria among Sabahan bank customers in selecting their Islamic mortgage providers. Second, this study will also investigate choice criteria among Sabahan with regard to gender, religion, monthly income, and race. This study uses a quantitative study similar to what employed by (Lymperopoulos et al. 2006; and Devlin, 2002). Frequencies, independent samples t-test, and ANOVA were used to analyze the data. The results of the study suggest that main factors affecting Islamic mortgage providers, among others, are price of financing, fair and just transaction, lend amount, professional advice and fast and efficient services. Furthermore, the results also reported that a number of significant differences with regard to gender, religion, monthly income, and race are found. Of these, the large portion of significant differences was contributed by monthly income. At this point, the study is also still weakened by two limitations, but still, it creates an opportunity for other researchers to explore them deeply in the future. With regard to implications, this study offers inputs for management decision among Islamic mortgage providers (i.e. Islamic banks). In addition, it is able to increase the literature in the area of home loans/financing. Overall, this study has contributed for the Islamic banking literature by providing information on choice criteria for Islamic mortgage providers’ selection among Sabahan.

INTRODUCTION
The study on choice criteria for Islamic home financing has been overlooked by many researchers in banking selection criteria (Dusuki and Abdullah, 2006; Devlin and Gerrard, 2004; Lee and Marlowe, 2003; Karjaluoto, 2002; Almossawi, 2001; Elliot et al., 1996; Kennington et al., 1996; Reeves and Bednar, 1996; and Boyd et al., 1994). Relatively, there exists scarce study in investigating choice criteria for choosing Islamic mortgage providers in Kota Kinabalu, Sabah, East Malaysia, Malaysia. Nevertheless, the four works by Lymperopoulos et al. (2006), Devlin and Ennew (2005), Devlin (2002) and Ford and Jones (2001) examined the choice criteria used for a mortgage provider selection. Still, there is little attention made by these studies to examine choice criteria on the basis of Islamic mortgage providers’ selection. This has left a motivation for the current study to investigate choice criteria for Islamic mortgage providers.

In Islamic finance, the issues of gharar and interest are considered haram or prohibited. This issue has been discussed further in many works (Iqbal and Mirakhor, 2007; Khir et al., 2008; Haron, 2005). As such, Islamic mortgage or Islamic home financing is defined as financing that is secured by the real property and provide a schedule of payments of profit rate (i.e. the rate charged by Islamic banks) and repayment of the principal to a bank. This definition is similar to what Tse (1997) explained, however Tse (1997) stresses on ‘payments of interest’ for conventional mortgage loans, which is impermissible in Islamic practice for Islamic mortgage. Unlike conventional mortgage providers, Islamic mortgage providers practice profit rate instead of interest rate (Khir et al., 2008). Recently in Malaysia, the practice of Islamic mortgage or Islamic home financing is available in two principles notably Bai Bithaman Ajil (BBA) and Musharakah Mutanaqsah. The former is
related to debt financing and the second is related to equity financing in Islamic finance framework (Khir et al., 2008).

Recently many banks in Malaysia offer Islamic financing, therefore they sometimes can be called as Islamic mortgage providers. As seen previously, there is limited information available on how Sabahan choose bank for their Islamic home financing. On the basis of this argument, the objectives of this study are twofold. First, this study will rank choice criteria by Sabahan bank customers. Second, this study will also investigate choice criteria by segregating them with respect to demographic elements namely gender, religion, monthly income, as well as race. By investigating choice criteria for an Islamic mortgage provider selection, the literature in this area of knowledge can be added into the limited knowledge available in choice criteria for Islamic financing. Both practitioners and academicians will benefit from the study results. Needless to say, this current study is unique due to two reasons. First, this study sample is using the local people of Sabah or Sabahan as respondents, which are limited to explore previously (i.e. Dusuki and Abdullah, 2007). Second, this study proposes two criteria namely ‘longer financing period’ and ‘fair and just transaction’ which are limited to investigate in previous studies (Dusuki and Abdullah, 2006; Devlin and Gerrard, 2004; Lee and Marlowe, 2003; Karjaluoto, 2002; Almossawi, 2001). Overall, this paper is uniquely brought the perception of Sabahan on Islamic mortgage providers, which is also varied with regard to demographic factors.

This paper is structured as follows. The first section briefly outlines the introduction on choice criteria for Islamic mortgage providers’ selection. This will be followed by discussion on a review of the literature and study methodology will be presented. Subsequently, the analysis of study results will be presented. The final part considers conclusion and implications of study.

LITERATURE REVIEW

In general, previous studies have demonstrated the choice criteria for banking selection without specifying their study in “choice criteria for Islamic mortgage providers’ selection”. To our knowledge, there are four works by Lymperopoulos et al. (2006), Devlin and Ennew (2005), Devlin (2002) and Ford and Jones (2001) examined the choice criteria used for a mortgage provider selection. Evidently, these studies have still overlooked the choice criteria for Islamic mortgage providers’ selection. Moreover, Karjaluoto (2002) also investigated more specific product by focusing on mode of bill payment. On the other hand, there are many studies examine the choice criteria for a banking selection in general (Dusuki and Abdullah, 2006; Devlin and Gerrard, 2004; Lee and Marlowe, 2003; Almossawi, 2001; Kennington et al., 1996; Elliot et al., 1996; Boyd et al., 1994; Khazeh and Decker, 1992; Kaynak et al., 1991; and Tan and Chua, 1986). The following provides a discussion of literature based on findings of the studies.

*Product choice criteria ---specific*

The recent work by Lymperopoulos et al. (2006) investigated home loans market in Greece. Lymperopoulos et al.’s (2006) study utilized about 1,092 bank customers in the greater area of Athens. Lymperopoulos et al. (2006) found that bank service quality is the most element that customers consider in order to select their mortgage providers. Additionally, product attributes, access, and communication are also considered important factors in selecting mortgage provider. On the contrary, Devlin (2002) investigated home loans market in UK. Evidently, Devlin (2002) investigated 4,200 bank customers. Service quality was found to be the least important choice criterion. This result is not consistent to what Lymperopoulos et al. (2006) found.

In more detail, Devlin (2002) found that professional advice is the most common choice criterion. Additionally, interest rates, loan availability, and previous relationship with the bank, are considered important factors in selecting mortgage provider. On the other hand, service quality was found to be the least important choice criterion. Devlin also showed that the importance of the aforementioned choice criteria varies with respect to customers’ demographic characteristics. Devlin (2002) also found that bank customers
would choose mortgage providers that offers a reasonable lend amount, which is featured highly on the list of choice criteria.

Another work by Devlin and his colleague Ennew (2005) investigated the choice criteria for a range of financial services. One of the financial services studied by them is home loans. They found that professional advice is the most important factor for all customers to select their mortgage providers. The interest rate charged is also more important as a mortgage choice criterion. Furthermore, choosing a mortgage with an institution at which a previous mortgage or another account is held is more important for other financial services consumers. Moreover, Ford and Jones (2001 - Cited in Lymperopoulos et al., 2006; and Devlin, 2002) investigated the “choosing a mortgage” in London. They found that the choice criterion for home loans is mainly influenced by customers’ previous experience with the provider. In addition, the advice of intermediaries is also affected individual for a selection of a mortgage provider. Ford and Jones (2001) also found that reputation is the important criteria in selecting a mortgage provider.

Karjaluoto (2002) investigated Finnish bank customers on a mode of bill payment. Karjaluoto (2002) investigated 1,167 bank customers in Finland. The results of the study suggest that primary factors affecting the choice of a mode of bill payment are speed, security and trustworthiness, easy-to-use, and price of the payment. Some consumers appreciated short distance to a branch. Conversely, examples from friends and relatives, social contacts with the banking personnel, and bank’s name had a relatively low impact on selection of bill payment mode.

**Banking choice criteria ---general**

In Malaysia, based on our knowledge, the first study in banking choice criteria was initiated by Haron et al. (1994) in West Malaysia. In more detail, Haron et al. (1994) surveyed 301 Muslim and non-Muslim commercial bank customers in Malaysia to determine the selection criteria used in a dual banking environment (i.e. Islamic and conventional banks). Results of this study show that Muslims and non-Muslims valued almost the same factors when selecting their banks. The more highly scored factors were fast and efficient services, speed of transactions, friendliness of bank personnel, and confidentiality of bank. Furthermore, the study was also reported that “lower service charges” was ranked 8 and 13 for Muslim and non-Muslim, respectively. Conversely, size of bank, external appearance of bank and recommendations had a relatively low impact on selection of banking selection.

Dusuki and Abdullah (2007) examined bank customers on banking selection by dividing respondents into four regions in a Malaysia context. They reported that bank customers choose Islamic banks on the basis of a combination of Islamic and financial reputation and quality service offered by the bank. Bank customers also have a tendency to choose Islamic banks that have a good social responsibility practices, convenience, and product price. In addition, Dusuki and Abdullah (2007) and Haron et al. (1994) considered product pricing has an important impact in affecting bank customers’ decision process to choose Islamic mortgage providers.

To our knowledge, there exists scarce research conducted on “choice criteria for an Islamic mortgage provider” either in West Malaysia or in East Malaysia. Next is also a discussion on banking selection criteria, but in other countries such as Poland, USA, Bahrain, Turkey, and Singapore.

Kennington et al. (1996) examined the variables influencing customer choice of banks in Poland. According to the research findings, reputation, price, and service, were the key variables that consumers look for, when evaluating a bank. Moreover Kennington et al. (1996) found that the bank’s image, stability and continuity, the service-charge policy and the competitiveness of rates, the quick, polite and friendly service are the most important factors in explaining how customers choose banks. In addition, Kennington et al. (1996) showed that the area of service with respect to time, efficiency, and pleasant treatment, is critical for Poles and this is where the banks should be focusing their strategies.
With reference to the work of Boyd et al. (1994) in USA, bank reputation, interest on savings accounts, interest charged on loans, quick service and location in the city are five most important factors affecting bank customers’ selection for bank. In line with Kennington et al. (1996), the work of Boyd et al. (1994) argues that reputation is the chief choice criterion in explaining a selection for a mortgage provider.

In other work on banking selection in Bahrain, Almossawi (2001) found other choice criteria beyond reputation, which affects bank selection are parking space near the bank, friendliness of bank personnel and the availability of ATM machines. Obviously, reputation is the chief choice criteria as similar as Kennington et al. (1996) and Boyd et al. (1994). However, they are difficult to compare since these studies employed mostly different choice criteria. For instance, stability and continuity is employed in the study of Kennington et al. (1996) however, it is absent in the study of Almossawi (2001) and Boyd et al. (1994).

Elliot et al. (1996) investigated bank customers in USA. Elliot et al. (1996) found that price, speed, and access are particularly important. According to their research findings, most customers place a higher value on lower prices and higher transaction speeds than they do on personalised service, and they are willing to accept lower service levels in exchange for price breaks (Elliot et al. 1996). On the other hand, Reeves and Bednar (1996) suggested that customer service may be more important than price and that customers may use additional criteria beyond price, speed and access to choose between banks, according to where they live (large cities or countryside) and other market conditions.

Still in USA, Khazeh and Decker (1992) investigated bank customers’ decision criteria. Khazeh and Decker (1992) found that service-charge policy, reputation, competitiveness of loan rates, time required for loan approval and friendliness of tellers, are the most important factors in explaining how customers choose banks. Further, availability of financial advice was among the lowest ranking determinant attributes. On the contrary, with respect to the work of Kaynak et al. (1991) in Turkey, friendly employees, close branch locations to their homes, fast and efficient service, availability of credit and financial services counseling are particularly important in banking selection. Due to these differences, research on banking selection remains inconclusive and needs further investigation.

It is a fact that, in the past, people have a close relationship with their family member. On the basis of this statement, the study by Tan and Chua in 1986 in Singapore was proven that the advice from family and friends is more important than other attributes such as reputation, opening hours, speed of service, courteous personnel, location, and interest rates, in motivating bank selection. However, in the new millennium, many people have been separated by economy activities. For instance, the work of Gerrard and Cunningham (2001) has proven the statement. They found third party influences such as influence of friends, family and teachers are no longer important, while the important factor is security and confidentiality. It is okay to claim so, since individuals are now more independent regarding their perception and decision.

**METHODOLOGY**

**Sample**

The data of this study was generated by the use of survey work, which was conducted in November 2007. A total of 300 questionnaires were prepared for the survey work. The sample was only consisted of the local people of Sabah or Sabahan. Choosing Sabahan is mainly because of the limited study to investigate how Sabahan choose bank for home financing (Dusuki and Abdullah, 2007; and Haron et al., 1994). Due to time and financial constrains, only 250 questionnaires are able to distribute. Of these, only 211 questionnaires were usable, which gives us a response rate of 84.4 percent. No extra efforts are carried out in order to increase the number of respondents. Non-probability, quota sampling was implemented. The target population comprised the local people of Sabah, namely Kadazandusun, Bajau, Murut, Rungus, Bisaya and Kedayan, who have used Islamic banking products in Kota Kinabalu, Sabah, East Malaysia, Malaysia. This approach is similar to what employed by Lymperopoulos et al. (2006). It was reported that in Table 1, most of the respondents were
female with 52.1 percent and male with 47.9 percent. Employing gender is based on Lymperopoulos et al. (2006) and Devlin (2002). The sample was sufficient to compare Islam and Christian respondents, whereby the percentage was 59.7 percent and 40.3 percent, respectively. Choosing religion element is based on the work of Haron et al. (1994). As presented in Table 1, it also shows about the monthly income. It indicates Sabahan have a good salary to make a purchase of their dream house. The result showed about 57 percent of the respondents were earned RM1,000-RM2,000 per month and also about 16.6 percent of the respondents were earned RM2,000-RM2,500. Interestingly, this study has received a good response from Sabahan, where the sample consists of Kadazandusun, Bajau, Murut, Rungus, Bisaya and Kedayan. The samples of Sabahan have been overlooked in previous studies in Malaysia (Dusuki and Abdullah, 2007; and Haron et al., 1994).  

Table 1. Profile of Respondents

<table>
<thead>
<tr>
<th>No.</th>
<th>Items</th>
<th>Frequency</th>
<th>Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Gender</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Male</td>
<td>101</td>
<td>47.9</td>
</tr>
<tr>
<td></td>
<td>Female</td>
<td>110</td>
<td>52.1</td>
</tr>
<tr>
<td>2.</td>
<td>Religion</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Islam</td>
<td>126</td>
<td>59.7</td>
</tr>
<tr>
<td></td>
<td>Christian</td>
<td>85</td>
<td>40.3</td>
</tr>
<tr>
<td>3.</td>
<td>Monthly income (RM)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less 1000</td>
<td>48</td>
<td>22.7</td>
</tr>
<tr>
<td></td>
<td>1001-1500</td>
<td>74</td>
<td>35.1</td>
</tr>
<tr>
<td></td>
<td>1501-2000</td>
<td>46</td>
<td>21.8</td>
</tr>
<tr>
<td></td>
<td>2001-2500</td>
<td>35</td>
<td>16.6</td>
</tr>
<tr>
<td></td>
<td>2501</td>
<td>8</td>
<td>3.8</td>
</tr>
<tr>
<td>4.</td>
<td>Race</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Kadazandusun</td>
<td>53</td>
<td>25.1</td>
</tr>
<tr>
<td></td>
<td>Bajau</td>
<td>71</td>
<td>33.6</td>
</tr>
<tr>
<td></td>
<td>Murut</td>
<td>17</td>
<td>8.1</td>
</tr>
<tr>
<td></td>
<td>Rungus</td>
<td>18</td>
<td>8.5</td>
</tr>
<tr>
<td></td>
<td>Bisaya</td>
<td>23</td>
<td>10.9</td>
</tr>
<tr>
<td></td>
<td>Kedayan</td>
<td>29</td>
<td>13.7</td>
</tr>
</tbody>
</table>

Measures

The study constructs were measured on five (5)-point Likert scales indicating the importance of each factor in determining the selection. The measures used in this study are initially adopted from previous studies. However, two items were constructed mainly to better reflect choice criteria for Islamic mortgage providers’ selection. See the following:

1. Lower service charges (Almossawi, 2001; and Haron et al., 1994);
2. Price of financing (Dusuki and Abdullah, 2007; and Kennington et al., 1996);
3. Discount (Devlin, 2002);
4. Lend amount (Lymperopoulos et al., 2006; and Devlin, 2002);
5. Longer financing period (self-created);
6. Product range (Almossawi, 2001; Haron et al., 1994; Gerrard and Cunningham, 2001; and Devlin, 2002);
7. Fast and efficient services (Gerrard and Cunningham, 2001; and Haron et al., 1994);
8. Professional advice (Devlin, 2002);
9. Recommendation (Devlin, 2002, Almossawi, 2001; Gerrard and Cunningham, 2001; Kennington et al., 1996; Haron et al., 1994);
10. Branch location (Dusuki and Abdullah, 2007, Devlin, 2002; Almossawi, 2001; and Haron et al., 1994); and
11. Fair and just transaction (self-created).
Evidently, there are several reasons of why “longer financing period” and “fair and just transaction” are proposed. For the former, some individuals have possibility to finance their home more than 20 years (i.e. 30 years). Therefore, Islamic mortgage providers should have a tendency to offer the financing period of more than 30 years or according to the age of individuals such as 60+. For the latter, fair and just transaction is promoted in Islam in every part of individuals’ life including in obtaining Islamic mortgage. As such, discrimination according to religion and races are not compromised at all. Indeed, Islam teaches the followers to treat individuals and to be responsible of her or his doing. To sum up, these constructs are qualified to be tested whether they are valid or not in this present study.

Data analysis
The data were analyzed using three tools namely mean analysis, an independent samples t-test and ANOVA. The former is used to rank choice criteria among Sabahan bank customers. The latter is analyzed gender and religion with regard to choice criteria. Finally, ANOVA is used to analyze monthly income and race with regard to choice criteria

FINDINGS AND DISCUSSION OF RESULTS

Rank of choice criteria using mean analysis
As depicted in Table 2, the high-ranking choice criterion is price of financing. This result is consistent to what Dusuki and Abdullah (2007) and Kennington et al. (1996) found. As such, the lower the price the greater is the selection for Islamic mortgage providers among bank customers. Similarly, Devlin (2002) argues that price is important factor for bank customers select bank to use. The second rank choice criterion is fair and just transaction. It is highly predictable that bank customers will choose Islamic mortgage providers that promote fair and just practice. This criterion has overlooked in previous studies (Dusuki and Abdullah, 2006; Devlin and Gerrard, 2004; Almossawi, 2001; Kennington et al., 1996; and Boyd et al., 1994).

Table 2. Choice criteria and Mean

<table>
<thead>
<tr>
<th>Testable items</th>
<th>Rank</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price of financing</td>
<td>1</td>
<td>4.626</td>
<td>.550</td>
</tr>
<tr>
<td>Fair and just transaction</td>
<td>2</td>
<td>4.564</td>
<td>.609</td>
</tr>
<tr>
<td>Lend amount</td>
<td>3</td>
<td>4.521</td>
<td>.657</td>
</tr>
<tr>
<td>Professional advice</td>
<td>4</td>
<td>4.450</td>
<td>.648</td>
</tr>
<tr>
<td>Fast and efficient services</td>
<td>5</td>
<td>4.441</td>
<td>.662</td>
</tr>
<tr>
<td>Lower service charges</td>
<td>6</td>
<td>4.431</td>
<td>.798</td>
</tr>
<tr>
<td>Discount</td>
<td>7</td>
<td>4.327</td>
<td>.794</td>
</tr>
<tr>
<td>Branch location</td>
<td>8</td>
<td>4.232</td>
<td>.866</td>
</tr>
<tr>
<td>Product range</td>
<td>9</td>
<td>4.218</td>
<td>.839</td>
</tr>
<tr>
<td>Longer financing period</td>
<td>10</td>
<td>4.104</td>
<td>1.046</td>
</tr>
<tr>
<td>Recommendation</td>
<td>11</td>
<td>3.910</td>
<td>.908</td>
</tr>
</tbody>
</table>

Selecting an Islamic home financing from Islamic banks that was prepared to lend the required amount also featured highly on the list of choice criteria. Bank customers have different priority on ‘lend amount’ for their dream house. This is relevant to their financial capacity. This result is consistent to what Devlin (2002) found. Devlin (2002) argues that lend amount is one of the important factors why people select bank for their home loans. Moreover, professional advice is also featured highly on the list of choice criteria. In this case, bank customers will choose Islamic mortgage providers that provide a clear advice, correct and interesting to hear. It is argued here, that bank customers have different level of information on Islamic mortgage providers. Therefore, banks must have experts to work with this issue. This study is somewhat in line with a previous study (Devlin, 2002), who found professional advice as also the criteria why bank customers choose a mortgage provider. Fast and efficient services is ranked number 5. This criterion is located somewhere between the high ranked criteria and low ranked criteria. Not to mention, previous studies such as Haron et al.
(1994) argue that fast and efficient services is important criterion for bank selection. As such, this criterion is also on the list of choice criteria. Another important criteria but with small mean, among others, are lower service charges and discount. It is also necessary to highlight that the least important is that concerning branch location, product range, longer financing period and recommendation.

**Independent samples t-test**

In order to develop more insights into the factors affecting the choice of Islamic mortgage providers, a number of independent samples t-test are conducted. This test compares the means for two groups of cases such as male and female respondents. Here we consider a series of t-tests to compare the mean ratings (Devlin, 2002).

### Table 3. Choice criteria and gender

<table>
<thead>
<tr>
<th>Testable items</th>
<th>Male</th>
<th>Rank</th>
<th>Female</th>
<th>Rank</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price of financing</td>
<td>4.614</td>
<td>2</td>
<td>4.636</td>
<td>1</td>
<td>.273</td>
</tr>
<tr>
<td>Fair and just transaction</td>
<td>4.624</td>
<td>1</td>
<td>4.509</td>
<td>3</td>
<td>.008***</td>
</tr>
<tr>
<td>Lend amount</td>
<td>4.465</td>
<td>3</td>
<td>4.573</td>
<td>2</td>
<td>.005***</td>
</tr>
<tr>
<td>Professional advice</td>
<td>4.445</td>
<td>5</td>
<td>4.455</td>
<td>4</td>
<td>.013***</td>
</tr>
<tr>
<td>Fast and efficient services</td>
<td>4.465</td>
<td>4</td>
<td>4.418</td>
<td>6</td>
<td>.417</td>
</tr>
<tr>
<td>Lower service charges</td>
<td>4.426</td>
<td>6</td>
<td>4.436</td>
<td>5</td>
<td>.826</td>
</tr>
<tr>
<td>Discount</td>
<td>4.297</td>
<td>7</td>
<td>4.355</td>
<td>7</td>
<td>.295</td>
</tr>
<tr>
<td>Branch location</td>
<td>4.297</td>
<td>8</td>
<td>4.173</td>
<td>10</td>
<td>.892</td>
</tr>
<tr>
<td>Product range</td>
<td>4.238</td>
<td>9</td>
<td>4.200</td>
<td>9</td>
<td>.254</td>
</tr>
<tr>
<td>Longer financing period</td>
<td>3.941</td>
<td>11</td>
<td>4.255</td>
<td>8</td>
<td>.502</td>
</tr>
<tr>
<td>Recommendation</td>
<td>4.099</td>
<td>10</td>
<td>3.736</td>
<td>11</td>
<td>.164</td>
</tr>
</tbody>
</table>

Note: ***Significant difference at 5% level

As presented in **Table 3**, there are a small number of significant differences found for the different gender groups. Fair and just transaction, lend amount and professional advice are significant at 5 percent. This means, null hypothesis is rejected. Once this null hypothesis is rejected, a conclusion can be made, that is discrepancy exists between both male and female samples with respect to the three criteria, as said earlier. However the remainders about 8 criteria are found to be insignificant. Statistically speaking, they are exactly the same for both male and female samples.

### Table 4. Choice criteria and religion

<table>
<thead>
<tr>
<th>Testable items</th>
<th>Islam</th>
<th>Rank</th>
<th>Christian</th>
<th>Rank</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price of financing</td>
<td>4.651</td>
<td>2</td>
<td>4.588</td>
<td>1</td>
<td>.279</td>
</tr>
<tr>
<td>Fair and just transaction</td>
<td>4.667</td>
<td>1</td>
<td>4.412</td>
<td>4</td>
<td>.000***</td>
</tr>
<tr>
<td>Lend amount</td>
<td>4.556</td>
<td>3</td>
<td>4.471</td>
<td>2</td>
<td>.294</td>
</tr>
<tr>
<td>Professional advice</td>
<td>4.484</td>
<td>5</td>
<td>4.400</td>
<td>5</td>
<td>.780</td>
</tr>
<tr>
<td>Fast and efficient services</td>
<td>4.524</td>
<td>4</td>
<td>4.318</td>
<td>6</td>
<td>.637</td>
</tr>
<tr>
<td>Lower service charges</td>
<td>4.413</td>
<td>6</td>
<td>4.459</td>
<td>3</td>
<td>.154</td>
</tr>
<tr>
<td>Discount</td>
<td>4.365</td>
<td>7</td>
<td>4.271</td>
<td>7</td>
<td>.733</td>
</tr>
<tr>
<td>Branch location</td>
<td>4.294</td>
<td>8</td>
<td>4.141</td>
<td>8</td>
<td>.966</td>
</tr>
<tr>
<td>Product range</td>
<td>4.286</td>
<td>9</td>
<td>4.118</td>
<td>9</td>
<td>.001***</td>
</tr>
<tr>
<td>Longer financing period</td>
<td>4.175</td>
<td>10</td>
<td>4.000</td>
<td>10</td>
<td>.151</td>
</tr>
<tr>
<td>Recommendation</td>
<td>4.016</td>
<td>11</td>
<td>3.753</td>
<td>11</td>
<td>.676</td>
</tr>
</tbody>
</table>

Note: ***Significant difference at 5% level
As depicted in Table 4, there are a small number of significant differences found for the different religion groups, which lead to the rejection of null hypotheses for fair and just transaction and product range. Evidently, the Levene’s test for equality of variances in Islam and Christian samples is significantly different (p=0.000, p<0.05) for fair and just transaction. This means, null hypothesis is rejected. Once this null hypothesis has rejected, a conclusion can be made, that is discrepancy exists between both Islam and Christian samples. Similarly, both Islam and Christian samples are significantly different (p=0.001, p<0.05) for product range. Practically speaking, they are different with respect to product range. However, the remainder about nine criteria is found to be insignificant. Statistically speaking, they are the same for both Islam and Christian samples.

ANOVA by race
The results of the ANOVA test in Table 5 yielded a small number of statistically significant differences in means between the different race groups. In more detail, price of financing is significant between the different race groups (F=2.790, p-value=0.018). Similarly, fast and efficient services is also significant between the different race groups (F=2.887, p-value=0.015). These results indicate that null hypotheses are rejected which mean all race groups have different perception and preference for two choice criteria, as noted here. On the other hand, about 9 choice criteria found insignificant. It means, the different race groups have no impact on Fair and just transaction; Lend amount; Professional advice; Lower service charges; Discount; Branch location; Product range; Longer financing period; and Recommendation. Practically speaking, the above-mentioned nine choice criteria exactly perceived the same among respondents, regardless they are Kadazandusun, Bajau or Rungus, to name a few.

<table>
<thead>
<tr>
<th>Testable items</th>
<th>Kadazandusun</th>
<th>Bajau</th>
<th>Murut</th>
<th>Rungus</th>
<th>Bisaya</th>
<th>Kedayan</th>
<th>F</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair and just transaction</td>
<td>4.434</td>
<td>4.676</td>
<td>4.235</td>
<td>4.556</td>
<td>4.652</td>
<td>4.655</td>
<td>2.246</td>
<td>.051</td>
</tr>
<tr>
<td>Product range</td>
<td>4.208</td>
<td>4.268</td>
<td>4.059</td>
<td>4.056</td>
<td>3.957</td>
<td>4.517</td>
<td>1.510</td>
<td>.188</td>
</tr>
</tbody>
</table>

Note: ***Significant difference at 5% level

ANOVA by monthly income
The results of the ANOVA test in Table 6 yielded some statistically significant differences in means between the different monthly income groups. There are three choice criteria found insignificant. In more detail, lower service charges is insignificant between the different monthly income groups (F=.540, p-value=.707). Similarly, discount is also insignificant for the different monthly income groups (F=.725, p-value=.576). Lastly, recommendation is also insignificant for the different monthly income groups (F=2.030, p-value=.091). These results indicate that monthly income seems to have no impact on lower service charges, discount, and recommendation due to their minor impact in affecting bank customers’ decision. The services
charges and discount offered by Islamic mortgage providers are not much different from one to another. Therefore, their impacts will be smaller for Sabahan. Not surprisingly, the following criteria are statistically significant at 5 percent, Price of financing; Fair and just transaction; Lend amount; Professional advice; Fast and efficient services; Branch location; Product range; and Longer financing period.

Table 6. Choice criteria and monthly income (RM)

<table>
<thead>
<tr>
<th>Testable items</th>
<th>Mean</th>
<th>ANOVA by race</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less than 1000</td>
<td>1001-1500</td>
</tr>
<tr>
<td>Price of financing</td>
<td>4.771</td>
<td>4.581</td>
</tr>
<tr>
<td>Fair and just transaction</td>
<td>4.625</td>
<td>4.689</td>
</tr>
<tr>
<td>Lend amount</td>
<td>4.688</td>
<td>4.621</td>
</tr>
<tr>
<td>Professional advice</td>
<td>4.729</td>
<td>4.595</td>
</tr>
<tr>
<td>Fast and efficient services</td>
<td>4.438</td>
<td>4.662</td>
</tr>
<tr>
<td>Branch location</td>
<td>3.917</td>
<td>4.270</td>
</tr>
<tr>
<td>Product range</td>
<td>4.354</td>
<td>4.419</td>
</tr>
</tbody>
</table>

Note: ***Significant difference at 5% level

CONCLUSION AND PRACTICAL IMPLICATIONS

In this study, an effort was made to study choice criteria for Islamic mortgage providers concerning bank customers in Sabah, who are mainly the bumiputra. The employed choice criteria mostly were extracted from previous studies (i.e Lymeropoulos et al. 2006; and Devlin, 2002). However, two new elements were added in the survey in order to better reflect choice criteria for Islamic mortgage providers’ selection. This study has reported that the most five important factors why Sabahan bank customers choose Islamic mortgage providers are price of financing, fair and just transaction, lend amount, professional advice and fast and efficient services. Most importantly, this study fills the research gap in the financial services research by providing new results of different kinds of customer types and their preferences with regard to Islamic mortgage providers.

With regard to the study results, it was reported that, there are a small number of significant differences found for the different gender groups. Fair and just transaction, lend amount and professional advice are significant at 5 percent. As such, different approaches need to be introduced by Islamic mortgage providers. For instance, male customers will be entertained by promoting a good conduct of practice in handling mortgage transactions. This issue needs to be taken into account when offering a service to male customers. For the purpose, a guideline needs to introduce to promote the fairness of bank treatment for different gender.

It seems that Sabahan are also different in two choice criteria namely fair and just transaction and product range with regard to religion at 5 percent. Therefore, Islamic mortgage providers should offer adjustable services in overcoming these criteria. For instance, product range should be varied for Muslim and non-Muslim, but still it carried the Islamic values. However, for insignificant criteria, Islamic mortgage providers can target them using a catch all marketing campaign.
The results of the study also suggest that about nine factors concerning choice criteria for Islamic mortgage providers were equally important to the different race groups (i.e. Kadazandusun, Bajau etc). Among others are, fair and just transaction and lend amount. No statistical differences were found in means of these between the groups. On the contrary, the study is also reported that price of financing and fast and efficient services are found to be statistically differences. In this case, price and fast and efficient services are sensitive to different race groups. For the purpose, Islamic mortgage providers should offer adjustable pricing scheme to the different race groups. Similarly, fast and efficient services should be enhanced to be given according to the need of individuals from the different race groups.

Furthermore, the results of the study suggest that about two factors concerning choice criteria for Islamic mortgage providers were equally important to the different monthly income groups. Among others are lower service charges, discount, and recommendation. No statistical differences were found in means of these between the groups. On the contrary, the study is also reported about eight choice criteria found to be statistically significant. For the purpose, Islamic mortgage providers should provide different treatment for the different monthly income groups. For instance, those who earned less than RM1,000 per month are concerned too much on price of financing as compared with those who earned more than RM2,000 per month. For the purpose, Islamic mortgage providers need to offer price discrimination for both groups, whereby the price is must be fair for both groups. Price should be lower for lower income earners and higher/reasonable price for higher income earners. It is reasonable to apply Malaysian taxation concept to this pricing issue.

Like previous studies (Lymperopoulos et al., 2006; Devlin, 2002; and Haron et al., 1994), this current study is also suffered from a number of limitations. First, this study is only confined to Kota Kinabalu, Sabah, East Malaysia, Malaysia. Based on this argument, an interesting avenue for future research might be comparisons between different cities in East Malaysia, as a preliminary step. It might be possible to compare samples between Sabahan and Sarawakian in the future. Second, the testable items used in this study are not comprehensive. Therefore, more testable items must be incorporated for the future research in order to produce more accurate results on choice criteria for Islamic mortgage providers’ selection among Sabahan.

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THEORETICAL MODEL OF PROFIT-LOSS SHARING AND INVESTMENT

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ABSTRACT
This paper attempts to answer the impact of Islamic banks’ financing transactions on the economy. Will the types of financing of the Islamic banks enhance investment level in the economy, through its impact on capital stock and user cost of capital? Financially, Islamic banks are expected to increase investment due to the elimination of fixed cost element in the user cost of capital. This paper elaborate Islamic modes of financing which is very different from its conventional counterpart through Profit and Loss Sharing (PLS) mechanism to investment behavior. The PLS mechanism is reflected by equity based financing (mudharabah/musharakah). In addition, Non-PLS (e.g. murabahah) mechanism is also considered in the discussion of this study.

INTRODUCTION
A large volume of study has been done towards understanding the relation between financial intermediaries and real economic activity. Among the earlier studies are Schumpeter (1911), Gurley and Shaw (1956), Tobin (1965), Goldsmith (1969), and McKinnon (1973). Schumpeter (1911) shows that the services provided by the financial intermediaries, such as mobilizing savings, evaluating projects, managing risk, monitoring managers and facilitating transactions are essential for technological innovation and economic development. Later, Gurley and Shaw (1956) highlight the vitally important intermediaries transmitting funds by issues of indirect financial assets to surplus units (savers) and purchases of primary securities in deficits units (investors). In other words, the financial intermediaries play an important role in the credit creation. Thus, the financial intermediaries affect economic activities if investment funds are generated from indirect finance and are not accessible from direct finance offer or self finance.

Then, Tobin (1965) and McKinnon (1973) prolong Gurley and Shaw propagation by extending their ‘new views’ which state that the essential role of financial intermediaries is to satisfy simultaneously the portfolio preferences of the borrowers as well as the lenders. Borrowers wish to expand their holding of real assets beyond the limit of their own net worth. Lenders, on the other hand, wish to hold part of all their net worth in assets of stable money value with negligible risk or default. Therefore, financial intermediation is crucial to economic activity. Since the appearance of the influential works of Gurley and Shaw (1956), Tobin (1965), Goldsmith (1969), McKinnon (1973) and Shaw (1973), a debate has been ongoing about the role of financial intermediaries in promoting long-run growth. Empirical studies have been sought to identify the link between financial intermediaries and economic growth (see for example Levine and Zervos (1996, 1998), Antje and Jovanovic (1993), Demirguc-Kunt and Levine (1996a and 1996b) and Demetriades and Hussein (1996). In

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addition Beck, et al. (2000), Romero-A´vila (2007) and Ang, (2008) contribute to the same notion of linking financial development and economic growth. Almost unanimously these studies suggest that a strong positive correlation, even after allowing room for significant exceptions such as market- and bank based financial system and measure of financial intermediaries’ activity, between the level of financial intermediaries and long-run economic growth.

Alternative to the role of financial intermediation on economic growth, a vast development economics literature argues that capital accumulation is the key factor underlying economic growth. According to this view, better financial intermediaries influence growth primarily by raising domestic savings rates (and hence, by increasing the fraction of savings channeled to investment) (see, Bandiera et al. (2000); Easterly and Levine (1999); Fry (1995); King and Levine (1994)) and by increasing the marginal productivity of investment (see, Bencivenga and Smith (1991) and Cooley and Smith (1998)). Most of the above research considers economies in which financial intermediaries can minimize the cost of acquiring and processing information about investment, which are costly if individual savers do it. In particular, King and Levine (1993b) state that the ability to acquire and process information leads to higher economic growth because intermediaries are capable of allocating funds to the most promising firm. Thus, financial intermediation stimulates the rate of technological innovation by providing funds to entrepreneurs with the best chances of successfully initiating new goods and production processes.

However, the tendency of the financial intermediaries, especially banks, as established by Peerce and Mullineaux (1996), is to provide debt to entrepreneurs. This is partly due to the role of banks as monitors and information specialists. Empirical work done by Levine and Zervos (1998) observe the role of financial intermediaries: to identify the profitable project activities, to exert corporate governance, mobilize resources, manage risk, and facilitate transaction. All these can pursue economic activities. By using bank credit as a proxy for the overall size of the banking sector, they find that financial development (bank credit) is a good prediction of economic growth, capital accumulation, and productivity growth.

From the Islamic economic perspective, however, funds (or money) channeled through financial intermediaries are treated as capital for investment. Capital as factor in production must first be produced before it can be used to generate goods and services. In this perspective, capital is not produced to generate consumer goods but for the usage of firms in producing those goods, i.e., capital is a mean towards production through creative and innovative entrepreneurial efforts. Therefore, money becomes an instrument for real productive effort, asset creation, value added as well as for the expansion of the physical economic activity in a manner that benefits all sectors and which participates in the economy as a whole. In addition, studies by Ahmad (1978a), Khan and Mirakhor (1992) and Abdul Ghafar (1993) suggest that profit and loss sharing (PLS) system, as the utmost fundamental difference distinguishing Islamic banking and finance from its conventional counterpart, can be viewed as alternative mechanism in channeling funds to avoid the interest-based debt, which is prohibited. PLS contract is conducted through two types of contract, mudharaba and musharaka. Financing based on these two contracts might enhance the level of investment due to prioritizing sound investment projects, rather than ability to repay the debt, when granting the financing, and hence improve the efficiency of resource allocation.

But, the study that relates those system and investment is very rare. Except, Presley and Sessions (1994) who have shown that the use of the prevalent alternative method of financier remuneration (i.e. mudarabah), under certain conditions, leads to an enhanced level of investment. By applying the standard model of investment by Holmstrom and Weiss (1985) and Meyer (1986), we will prove theoretically that profit-loss sharing may

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31 This system is a manifestation of Islamic injunction to conduct any business transaction in a manner that ensures fairness and justice for all parties involved. Under this system, therefore, risk and return will be equitably balanced, as Ahmad (1978a) stated that the rationale of the principle that there should be no profit-sharing without risk-sharing (al ghunn bi-l-ghurm) is that the justification for earning profit is having engaged in an economic venture and thus contributed to the economy. PLS contract is conducted through two types of contract, mudharaba and musharaka.
permit a more efficient revelation of any informational advantage the manager may have over the latter. Therefore, this study would produce a different view on the current emerging literature that studies the relationship between finance and economic performance on two aspects: first, Islamic bank is able to produce a better functioning institution that can improve resource allocation and promotes economic growth. Second, as a direct and accurate measure of investment, our study would suggest investment-oriented bank financing rather than debt financing.

The remaining discussion will mainly cover the theoretical model which adopts Jorgensen’s paper. Modification of different types of contracts to follow suit with Islamic banking/finance concept is the main theme of the discussion in the next section. The contracts include only Profit and Loss Sharing (PLS: mudharaba and musharaka) and Non Profit and Loss Sharing (NPLS: murabaha). The last section will conclude the paper.

THE MODEL

The standard models that examine the investment behaviour are many. However, in this paper, we will construct the model of investment which can capture the importance of price variables like taxes and interest rate, and quantity variables like output. This model is constructed along the neoclassical model originally formulated by Jorgensen (1963) and later extended by many others such as Agarwala and Goodson (1969). However, our model deviates from the standard neoclassical model in three aspects. First, we replace the interest rate with mark-up rate (for murabahah financings); or profit rate (for profit-loss-sharing financing). Second, we introduce zakat. Third is the financial decisions undertaken by the firms. In this case, managers prefer to use profit-loss-sharing financing since they are willing to share the risk of financing. It is also due to the potential of having relatively cheaper cost of financing under profit-loss-sharing scheme.

In the usual formulation of the neoclassical model, the firm is a price taker and maximises the following net worth:

\[ W = \int^\infty_0 [R(t) - D(t)] dt \]  

Subject to:

\[ Y = f(K, L) \]  

\[ R^* = \Psi(I, K) \]  

The maximization of equation (1) is subject to equation (2), i.e., the production function where output \( Y \) depends on the capital stock \( K \) and labour input \( L \); and equation (3) an increasing and concave installation cost function for investment; and \( I \) is real investment. In what follows we omit \( t \)-subscripts for ease of exposition.

In equation (1), \( R \) is revenue before taxes, and \( D \) is zakat. It shows that net worth is defined as the integral of net revenues; all prices, including the mark-up rates, are taken as fixed. Net revenue, as shown in equation (4) is defined as current revenue less expenditure on both current and capital account, including zakat.

\[ R = pY - sL - qI \]  

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32 There are at least five models: accelerator model; cash flow model; neoclassical model; modified classical model; and Q-model. See further in Dixit and Pindyck (1994)
where $p$ is the price of output, $s$ is the wage rate, $q$ is the price of capital goods, $Y$ is the quantity of output, $L$ the quantity of variable input, say labour, and $I$ the rate of investment.

The managers has to decide on their financial decisions, i.e., Non-PLS or PLS financings or both. In the Non-PLS, firm uses the debt-based related instrument and pays a fixed sum to Islamic banks. This is similar to the original neo-classical model due to technically similar nature between conventional interest based system and Non-PLS products such as murabahah. The firm may also use the profit-loss-sharing financing and share the profit with the shareholder. Hence, we have the following equations, i.e., equations (5) and (6) that represent the Non-PLS (murabahah) and PLS financings, respectively.

\[
R_{\text{NPLS}} = pY - sL - qI, \quad (5)
\]
\[
R_{\text{PLS}} = pY - sL. \quad (6)
\]

In equation (6), we drop the price of capital due to the fact that under PLS financings the cost of capital does not exist.

Following Jorgensen (1963) let $u$ be redefined as the rate of zakat, $v$ the proportion of replacement chargeable against income for tax purposes, $w$ the proportion of mark-up, and $x$ the proportion of capital losses chargeable against income; where $K$ is capital stock and $\delta$ the rate of replacement, zakat is

\[
D = u[pY - sL - (v\delta q + wrq - xq)K] \quad (7)
\]

Equation (7) will be distinguished to allow application of Islamic products based on PLS and Non-PLS. For Non-PLS modification will be to redefine $w$ as the proportion of mark-up, and $r$ as mark-up, meanwhile for $q$ is similarly define as price of capital goods, therefore the direct taxes for Non-PLS will be similar as follows

\[
D_{\text{NPLS}} = u[pY - sL - (v\delta q + wrq - xq)K] \quad (8)
\]

As for the PLS the only taxes applied for this product is when the profits distributed to each contracting party is treated as income which then income taxable, therefore the equation will be modified as follows

\[
D_{\text{PLS}} = u[pY - sL - (v\delta q - xq)K] \quad (9)
\]

To generate marginal productivity conditions, we maximize equation (1) to a standard neoclassical production function, equation (2), and the constraint that the rate of growth of capital stock is investment less replacement, equation (3), hence, the marginal productivity of labour and capital are respectively given as follows:

\[
\frac{\partial Y}{\partial L} = \frac{s}{p} \quad (12)
\]
\[
\frac{\partial Y}{\partial K} = \frac{q}{p} \left[ \frac{1 - u}{1 - u} - \frac{1 - u}{1 - u} \delta + \frac{1 - u}{1 - u} r - \frac{1 - u}{1 - u} \frac{q}{q} \right] \quad (13)
\]

The above marginal productivity of labour is similar for both PLS and Non-PLS.
Meanwhile for marginal productivity of capital for Non-PLS will be similar expression as above but different definition for \( w \) and \( r \).

\[
MP_{K(NPLS)} = \frac{\partial Y}{\partial K} = q \left[ \frac{1 - uw}{1 - u} \delta + \frac{1 - uw}{1 - u} r - \frac{1 - ux}{1 - u} \frac{q}{u} \right]
\]  

(15)

As for PLS, \( MP_K \) will be reformulated as follows

\[
MP_{K(PLS)} = \frac{\partial Y}{\partial K} = q \left[ \frac{1 - uw}{1 - u} \delta - \frac{1 - ux}{1 - u} \frac{q}{u} \right]
\]  

(16)

Jorgensen (1963) called the numerator of the second fraction is the "shadow" price or implicit rental of one unit of capital service per period of time and be called this price the user cost of capital. He further assumed that all capital gains are regarded as "transitory," so that the formula for user cost, say \( c \), reduces to

\[
c = q \left[ \frac{1 - uw}{1 - u} \delta + \frac{1 - uw}{1 - u} r \right]
\]  

(17)

Modification for Non-PLS product is only by redefining \( w \) and \( r \) as previously mentioned.

\[
c_{(NPLS)} = q \left[ \frac{1 - uw}{1 - u} \delta + \frac{1 - uw}{1 - u} r \right]
\]  

(18)

As for PLS product user cost of capital will be modified as follows

\[
c_{(PLS)} = q \left[ \frac{1 - uw}{1 - u} \delta \right]
\]  

(19)

Comparing user costs of capital under interest based system and non-interest based system will result in the following possibilities:

- user cost of capital under IBS might be greater or smaller or similar to that under Non-PLS \( c_{NPLS} \), it is crucially dependent upon which one is higher between interest rate and mark-up rate.
- user cost of capital under IBS is obviously greater than that under PLS \( c_{PLS} \), due to eliminating fixed element of interest rate.
- user cost of capital under Non-PLS is greater than that under PLS \( c_{NPLS} > c_{PLS} \)

Jorgensen (1963) elaborates further by letting \( K^* \) represent the desired amount of capital stock, if the production function is Cobb-Douglas with elasticity of output with respect to capital, \( \gamma \),

\[
K^* = \frac{pY_c}{c}
\]  

(20)

The formulation will be the same for both Non-PLS and PLS but with different definition of user cost of capital, \( c \), as mentioned beforehand.

\[
K_{(NPLS)} = \gamma \frac{pY}{c_{(NPLS)}}
\]  

(21)

\[
K_{(PLS)} = \gamma \frac{pY}{c_{(PLS)}}
\]  

(22)
However, following previous comparisons of user cost of capital it can be deduced that the desired capital stock will be higher whenever user cost of capital, $c$, is smaller, other things being held constant. Since $c$ is obviously smaller under PLS then the desired capital stock is greater under PLS. Whereas under Non-PLS the desired capital stock might be smaller or greater or equal to that under IBS.

$$K_{(NPLS)} < K^*$$
$$K_{(PLS)} > K^*$$
$$K_{(NPLS)} < K_{(PLS)}$$

Following Jorgensen (1963) further we suppose that the distribution of times to completion of new investment projects is fixed. Let the proportion of projects completed in time $\tau$ be $w_\tau$. If investment in new projects is $I_t^E$ and the level of starts of new projects is $I_t^N$, investment is a weighted average of past starts:

$$I_t^E = \sum_{\tau=0}^{\infty} w_\tau I_{t-\tau} = w(L)I_t^N$$

where $w(L)$ is a power series in the lag operator, $L$. We assume that in each period new projects are initiated until the backlog of uncompleted projects is equal to the difference between desired capital stock, $K_t^*$, and actual capital stock, $K_t$:

$$I_t^E = K_t^* - [K_t + (1 - w_0)I_{t-1}^N + ...]$$

which implies that

$$I_t^E = w(L)[K_t^* - K_{t-1}]$$

From previous discussion we have that there is difference level of $K^*$ under different schemes, for example, $K^*_{PLS} > K^*$. However in the last equation we cannot conclude whether or not the change/growth in the desired capital stock will be higher in one particular scheme (PLS) compared to other scheme (IBS), in short

$$I_t^E \leq I_{t(NPLS)} \leq I_{t(PLS)}$$

Furthermore for concreteness, Jorgensen (1963) considers the case of two intermediate stages, which will turn out to be anticipated investment, two quarters hence, and anticipated investment, one quarter hence. A similar approach can be applied to additional intermediate stages such as appropriations or commitments. The distribution of completions of the first stage, given new project starts, may be described by a sequence, say $\{v_{0\tau}\}$ ; similarly, the distribution of completions of a second stage, given completion of the first stage, may be described by a sequence $\{v_{1\tau}\}$. Finally, the distribution of investment expenditures, given completion of a second intermediate stage is described by a sequence $\{v_{2\tau}\}$. Where $I_{t1}^{E1E}$ represents completions of the first stage, $I_{t2}^{E2E}$ completions of the second stage, and $I_t^E$ actual investment, as before, we have:

$$I_{t1}^{E1E} = \sum_{\tau=0}^{\infty} v_{0\tau} I_{t-\tau} = v_0(L)I_t^N$$

$$I_{t2}^{E2E} = \sum_{\tau=0}^{\infty} v_{1\tau} I_{t-\tau} = v_1(L)I_t^N$$

$$I_t^E = \sum_{\tau=0}^{\infty} v_{2\tau} I_{t-\tau} = v_2(L)I_t^N$$
where \( \nu(L) \), \( \nu_1(L) \), and \( \nu_2(L) \) are power series in the lag operator. In this regards it also follows that there would be no conclusive result in comparing different schemes of product, between IBS and Non-IBS (PLS and Non-PLS).

Up to this point we have discussed investment generated by an increase in desired capital stock. Total investment, say \( I_t \), is the sum of investment for expansion and investment for replacement, say \( I_t^R \)

\[
I_t = I_t^E + I_t^R
\]  

(29)

We assume that replacement investment is proportional to capital stock. The justification for this assumption is that the appropriate model for replacement is not the distribution of replacements for a single investment over time but rather the infinite stream of replacements generated by a single investment; in the language of probability theory, replacement is a recurrent event. It is a fundamental result of renewal theory that replacements for such an infinite stream approach a constant proportion of capital stock for (almost) any distribution of replacements for a single investment and for any initial age distribution of capital stock. This is true for both constant and growing capital stocks. Representing the replacement proportion by \( \delta \), as before,

\[
I_t^R = \delta K_t
\]  

(30)

Previously it is indicated that the desired capital stock is larger in PLS system than that of either Non-PLS or IBS. It also is expected that the actual capital stock will follow the same line of reasoning, hence we could arrived at an indication that

\[
I_t^E < I_t^E_{(PLS)}
\]

\[
I_t^R < I_t^R_{(NPLS)}
\]

\[
I_t^{R_{(NPLS)}} < I_t^{R_{(PLS)}}
\]

combining this relationship with the corresponding relationship for investment in new projects, we have:

\[
I_t = w(L)[K_t^e - K_{t-1}^e] + \delta K_t
\]  

(31)

Since, from equation (29)

\[
I_t = I_t^E + I_t^R
\]

therefore,

\[
I_t < I_t^E_{(PLS)}
\]

\[
I_t < I_t^{R_{(NPLS)}}
\]

\[
I_t^{R_{(NPLS)}} < I_t^{R_{(PLS)}}
\]

Jorgensen (1963) used the assumption that capital stock is continued in use up to the point at which it is replaced, to obtain the corresponding relationships for gross investment at each of the intermediate stages, say \( I_t^{R_1} \) and \( I_t^{R_2} \)

\[
I_t^{R_1} = \nu_0(L)[K_t^e - K_{t-1}^e] + \delta K_t
\]  

(32)

\[
I_t^{R_2} = \nu_1(L)\nu_0(L)[K_t^e - K_{t-1}^e] + \delta K_t
\]  

(33)

we can also derive the following

\[
I_t^{R_2} = \nu_1(L)[I_t^{R_1} - \delta K_t] + \delta K_t
\]  

(34)

\[
I_t = \nu_2(L)[I_t^{R_2} - \delta K_t] + \delta K_t
\]  

(35)

\[
I_t = \nu_2(L)\nu_1(L)[I_t^{R_1} - \delta K_t] + \delta K_t
\]  

(36)
He further suggested that for empirical implementation of the theory of investment behaviour, it is essential that each of the power series \( \nu_0(L) \), \( \nu_1(L) \), and \( \nu_2(L) \) have coefficients generated by a rational function, for example,

\[
w(L) = \frac{s(L)}{t(L)} = \frac{v_2(L)v_1(L)v_0(L)}{v_2(L)v_1(L)v_0(L)}
\]

(37)

where \( s(L) \) and \( t(L) \) are polynomials. Then he will call the distribution corresponding to the coefficients of such a power series a rational power series distribution which follows the geometric and Pascal distributions.

The channeling of funds occurs from bank to firm. We assume that optimal investment can be achieved by increasing investment in firms that are “growing” and decreasing investment in firms that are “declining”. Since the sum of value added across all firms in the economy is GDP, and economic growth is typically measured as growth in GDP, growth in firm value added is the most natural way to measure firm growth. Therefore, we use growth in firm gross fixed capital formation to measure growth in investment, since depreciation is also not available. Islamic banks are expected to increase investment in the growing industries and decrease investment in the declining industries. Thus, although Islamic banks might not invest via equity-financing (mudharabah/musharakah) at a higher level, they do seem to allocate their investment better. This study complements an emerging literature that studies the relationship between finance and economic growth with special reference to Islamic bank financing. As a direct and accurate measure of investment, our study would suggest investment-oriented bank financing rather than debt financing. Hence, this study will shed light on the efficiency of mudharabah and musharakah contract financing contracts.

**CONCLUSION**

This paper has discussed Islamic bank financing and its connection with investment. The difference aspect of Islamic banking being highlighted mainly includes profit and loss sharing system as reflected in mudharaba and musharaka based financing. The main discussion follows relatively closely to the Jorgensen’s formulation to show the implications of applying PLS system in financing with respect to user cost of capital, capital stocks, and investment level.

The implications of introducing profit and loss sharing system as a replacement of interest rate system include the followings:

- User cost of capital is smaller in PLS scheme than that either in IBS or Non-PLS. In addition, it is inconclusive to compare user cost of capital in IBS and Non-PLS.

- The desired capital stocks and actual capital stock is higher under PLS system than that either under IBS or Non-PLS. In addition, it is also inconclusive to compare the desired capital stock and actual capital stock in IBS and Non-PLS.

- Investment level is higher under PLS system than that either under IBS and Non-PLS. In addition, it is also inconclusive to compare investment level in IBS and Non-PLS.

The inconclusiveness from comparison of IBS and Non-PLS might arise from the fact that in practical sphere interest rate and mark-up are unlikely different. The result of this discussion should also be viewed with restriction, in the sense that it assumes only single mechanism applied as this paper does not deal with any combination of the schemes, for example combination of PLS and Non-PLS scheme, to incorporate optimal debt-equity financing.

This paper adds to the understanding of the working of profit and loss sharing system in finance and economy through the betterment of investment mechanism. It is expected that using better financial and economic system, within which PLS mechanism being adopted, will foster economic development to the right direction.
It includes increasing output of the economy, rising economic growth and stabilizing price by maintaining equilibrium between aggregate demand and aggregate supply.

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SHARIAH COMPLIANT PARAMETERS RECONSIDERED

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ABSTRACT
Methods determining the legality of Shariah compliant instruments should be expanded beyond contractual approach as it tends to favor form over substance in discerning true label. New parameters should include financial reporting, legal documentation of contract and intent of the Shariah. The contract approach needs to capture the intent of the Shariah as it tends to overlook the adverse impact of product utilization to the general public such as financial shocks and crises arising from credit financing. Financial reporting reveals often than not, that in a contractually valid sale and leasing respectively, pre-ownership in the banking book may not take place. Legal documentations of Shariah compliant products have shown adversity towards customers when goods are not delivered or found defective or when customers defaulted on their debt obligation. Wholesome Shariah compliance should see consistency among the four parameters examined in this paper.

PROBLEM STATEMENT
This paper intends to examine an issue in Islamic finance pertaining to the role financial reporting, legal documentation and intent of the Shariah in determining the legitimacy of Islamic financial instruments. Currently Shariah scholars are the only parties responsible in determining Shariah compliant status of financial instruments. Their front-end role is common knowledge, that is issuing opinions on the legality of financial products offered by the Islamic banking, takaful, unit trust, fund and wealth management business. The push for innovation has many Islamic financial institutions (IFIs) to adopt conventional principles and instruments. Issues include bench-making bank profit rates against interest rates, penalty charges on late payments, charging profit from delay or installment payment, sale-buyback involving two parties, sale-buyback using three interrelated parties, sale-buyback at fixed price, lease and leaseback, purchase undertakings, sale of debt at discount, promise (waad), profit-rate swap and paying upfront profit on Islamic investments, securitization of receivables and future cash flows These unresolved issues have led many people including consumers to accuse Islamic finance as one that “closes the front door of riba while opening the back door of riba” or an activity only bearing “form over substance”. Disturbing mood such as these deserves an explanation.

In Islam, wealth can be created in many ways. Workers earn wages and salary by selling their labor. Retailers earn profits from the promotion and sale of their merchandizes. Lawyers and investment bankers earns fees by rendering their professional services. In other words, Islam cherishes the fact property changes hands by way of trade and commercial activities (al-bay'). When the transfer of property is transacted the wrong way (bathil), say by way of riba and gambling, and not through al-bay, the injustice (zulm) prevails.

FOUR METHODS IN DETERMINING SHARIAH COMPLIANCE

One who innovates will always go back to basic knowledge when something about his work is found inadequate. The same applies to innovation involving Islamic financial instruments. For example, it is of great importance to find ways to manage, say, liquidity. Through innovation, new methods are designed to improve liquidity in banking firms and hence increase efficient use of funds, thus maximizing bank’s earning. To

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avoid unnecessary losses arising from market volatilities by any means, hedging is inevitable. Innovation in Islamic financial instrument for hedging purposes help producers position themselves against these volatilities in a manner permitted by Islam.

The market is also looking for better ways to accommodate changes in the cost of funds in the existing home and car financing facilities. Entrepreneurial financing under a *musyarakah* framework is yet to be employed by Islamic banks. Hence, to take a leading role in economic growth, Islamic banking must innovate in order to command a niche in specific areas that conventional banks cannot compete.

When innovation in Islamic finance is highly sought for by the industry and other stakeholders, it is usually conducted along certain explicit *Shariah* principles. The common use of the expression "Shariah principles" which is to convey full compliance with Islamic law in the financial transactions is a norm today. Usually, adhering to *Shariah* principles or staying "Shariah compliant" means observing strictly to the permissibles (*halal*) and abstaining from the prohibited (*haram*) as commanded by Allah. In current practice, *Shariah* principles may well imply the Divine rules (*akham shari‘*) concerning interest (*riba*), ambiguities (*gharar*), gambling (*maisir*) and prohibited commodities such as intoxicants and pork. This method of aligning *Shariah* principles to the main and fundamental legal rulings (*akham*) concerning business and financial transactions as mentioned above, is both pragmatic and sensible. In this way, people can easily distinguish Islamic banking from conventional banking.

Principles can also mean values, major beliefs and doctrine rather rulings *per se*. In this way, it gives a broader perspective of the *Shariah* and helps accommodate a wider scope of thinking in Islamic finance. However, existing conventions may have positioned *Shariah* principles as synonymous with legal rulings. These principles such as the prohibition of *riba*, *gharar* and *maisir* in financial transactions are also distinct Islamic legal rulings (*hukm shari‘*). However, when *Shariah* principles are made equal to "legal rulings or values" (*akham*), it tends to narrow down the general meaning of *Shariah* principles into the purviews of permissables (*halal*) and prohibitions (*haram*).

It is here that the contract and *aqad* dimension of *fiqh muamalat* was raised to a level that overlooked the role of financial reporting and legal documentation of financial transactions. When a Shariah compliant product is found suspicious, it does not fit well into the financial reporting of transaction. The same affects the welfare of customers when legal documentations favored the Islamic financial institutions. These events further raised questions whether the contract has readily fulfilled the intent of the *Shariah* (*maqasid al-shariah*). The following sections examine each approach and argue that these approaches should complementary to each other and hold consistency to further ascertain the determinants of *Shariah* legality in financial transaction.

**The Aqad Approach**

In developing new Islamic financial products, *Shariah* principles have been applied as the litmus test of legality. In the conduct of innovation, *Shariah* scholars however tend to align *Shariah* principles around the parameters of *contract* (*'aqd*). In this way, the new product will received a *Shariah* compliant status when it has fully complied with the requirement of the contract at hand. Hence, *halal* and *haram* of actions pertaining to using the financial instruments are fully determined by the legality of a contract (*al-aqd*).

In Arabic, *al-aqd*” literally means an obligation or a tie. It is an act of “putting a tie to a bargain”. The *Mejella* has defined contract as “the obligation and engagement of two contracting parties with reference to a particular matter. Contract is a source of obligation and its faithful fulfilment is a duty in accordance with *Surah 5*, Verse 1 of the Qur’an: “Oh ye who believe, fulfill your undertaking” and then in another verse, the

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34 For more details on *aqd*, see Mahmood Sanusi and Saiful Azhar Rosly “Fiqh muamalat for Islamic Financial Practitioners” (unpublished), 2008.
Holy Qur’an call upon believers to observe their engagement as they will be accounted for all their engagements. Surah 17, verse 34 reads: “And fulfill every engagement (ahd) for every engagement will be inquired into (on the day of reckoning)”

The validity of contract rests on the fulfillment of the four principles of contract namely: 1) buyer and seller 2) price 3) subject matter 4) offer and acceptance. For an example, a valid subject matter means that firstly, it is pure (mal-mutawawim) and secondly, seller holds legal ownership of goods. Valid price means that price must be set on the spot and make known to the buyer. Valid buyer and seller mean they are rational (aqil baliq) enough to conduct the trade so as to understand their respective roles and obligations. In other words, the elements of ambiguities (gharar) must be avoided in all contracts in Islamic law as its presence will cause defects to the contract. When gharar exists in the contract, it will cease to become valid and consequently receive no legal protection. Some examples of contracts are given below:

**Murabaha contract**

From the aqad approach, the murabaha contract is valid because it has fulfilled all the requirement of a valid contract. The bank serves as the buyer while the customer as the seller. The object of trade is say, the home property. The price is known and agreed by both parties on the spot. But questions may be raised to further examine the validity of the contract. These questions include: 1) does the bank buy the asset and hold ownership prior to sale? 2) How is the murabaha price determined? 3) To what extent profit determination implicate time value of money since the murabaha deals with installment sale? 4) What happens when the customer defaulted on the murabaha facility? 5) What happens when the asset sold is found defective? For this reason, it is imperative to further indulge into new boundaries of knowledge to tighten the meaning of Shariah legitimacy beyond the context of aqad.

**The Maqasid Approach**

Shariah principles can best be understood from an angle it is destined for, namely the purposes and objectives of Islamic law (maqasid al-Shariah). This will prove more effective since it allows Islamic financial institutions to match their products and commercial viability more accurately to the demands of Islamic ethics and morality and hence justice (‘adl). This is because the maqasid of Shariah serves to do two essential things, namely tashsil, i.e. the securing of benefit (manfaah) and ibqa, i.e. the repelling of harm or injury (madarrah) as directed by the Lawgiver. In this respect, innovation in Islamic finance and all endeavours to test the legality of a new product must readily comply with the purpose (maqasid) of the Shariah.

Based on the above argument, it is worthy to examine what constitutes the maqasid al-Shariah. One purpose of the Shariah is the preservation and protection of the basic necessities (daruriyat) of man without which life would probably be filled with anarchy and chaos and thus become meaningless. Basic necessities in Islamic law are religion (Din), Life (Nafs), Family (Nasl), Intellect ('Aql) and Property (Mal). For example, the prohibition on drinking wine (khamr) is based on two reasons. First, the intoxication effect will make one lose his senses. This prohibition therefore serves to repel the harm of losing one's senses. The second is the protection of the intellect which also means preservation of benefits.

In relation to the protection of property (al-mal), the prohibition of riba serves to repel the harm incurred by the payment of interest as it depletes one's property. Thus, by prohibiting riba, the harmful effects (madarrah) of poverty and widening of the income gap can be pre-empted. Likewise, the positive Quranic attitude towards trade and commercial activities (al-bay') serves to secure the benefits of mutual help and equitable transactions ordinarily evident in the business environment. People engaging in business will take a natural path in dealing with risk and return as both move in a harmonious fashion. And by conducting al-bay and thus deriving benefits from it, it can make the business of money lending less profitable than trading.

35 For in depth examination of Shatibi’s theory, see Muhammad Khalid Masud “Islamic Legal Philosophy: A Study of Abu Isaq al-Shatibi’s Life and Thought”, Islamic Research Institute, Lahore 1977.
The *maqasid* of *Shariah* will also assure that an Islamic financial institution will provide services that can repel the harm (*madarrah*) commonly found in the Western mode of financing. If the harm is still obvious in the new Islamic financing product, it must be eliminated at all cost. Otherwise, the product will not reflect the true ideals of Islam. For example, hedging against price volatility is an important ingredient in business today. Manufacturers who buy raw material as inputs are on the lookout to buy them at the cheapest cost possible. Some will buy forward, i.e. buy the commodity now to be delivered and paid for at a specific future date. The price is set on the spot on the day the contract is arranged. There are serious disagreements among *Shariah* scholars on this matter. Some say this kind of forward contract is permissible as it has fulfilled the requirements of a valid contract while others say the contrary as the contract is akin to gambling (*maisir*) and therefore invites harm and injustice (*zulm*).

When the issue is examined from the contract (*’aqd*) perspective alone, i.e. applying rules of contract in determining legality, it may discount the very purpose of the *Shariah* and hence unable to repel the harm it is initially intended to do. If it can be proven that forward contract is free from harm either from the gambling element or ambiguities (*gharar*), then it should prove beneficial to Islamic finance and hence be adopted by Islamic financial institutions. However, if it is found valid (*sahih*) from the *’aqd* perspective but has been shown to have adversely affected the general welfare, it shall then remain prohibited since it has failed to repel the harm, thus defeating the very purpose of the *Shariah*.

Fulfilling the *maqasid* *Shariah* should therefore serves as the underlying principle of Islamic financial innovations as it safeguards rulings based on *fiqh* from moving into unwanted territory. The purpose (*maqasid*) of *Shariah* and the rulings on contracts should not conflict with each other. If it does, the *maqasid* shall stand above the rulings of contracts. This is because the former is based on the Divine Law while the latter is founded on human understanding (*fiqh*).

In this manner, the legality of a financial contract is judged not only from the contract (*aqd*) aspect but equally important its economic and social impacts (i.e. benefits and disbenefits) to the general public. For example, if Islamic financial products are found to pull people to fall into debts and bankruptcy, how can we explain it as a worthy alternative to conventional financing? On the contrary Islamic products should enhance economic growth, reduce poverty and bring happiness to human beings.

The recent subprime crisis in the United States should be a lesson to Islamic banking. Sale of mortgage loan called for the issuance of CDOs by special purpose vehicle (SPV) companies. The securitization of loan receivables by the SPV is an issue in Islamic finance. While *Shariah* allows securitization of physical assets, it prohibits the sale *murabaha* receivables although Malaysia *Shariah* scholars had allowed this. Although subprime crises is not caused by solely securitization but instead bad credit appraisal in loan origination, Islamic banks that runs on credit financing is still exposed to credit risk. In this way, the benefits and disbenefits of using products involving deferred payments such as *murabahah* should be examined in academic research so that the disbenefits of *murabahah* is proven substantially less than interest-bearing loans.

**Accounting and Financial Reporting Approach**

Accounting can be defined as the process of identifying, measuring and communicating economic information to permit informed judgement and decisions by users of the information\(^3^6\). In Islam accounting fall under the purview of *hisb* and part and parcel of the al-*hisbah* system.

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\(^3^6\) American Accounting Information, A Statement of Basic Accounting Theory (Evanston Illinois: American Accounting Association, 1966 pp.1)
The purpose of financial statements or financial reporting is to provide information about the financial strength, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. It serves to eliminate ambiguities (gharar) in financial contract through factual reporting of the said transaction. More importantly, financial reporting explained what exactly was transacted in the business dealings such that one is able to know whether, say, a transaction is a loan or a sale, whether a sale is a true one or not. This is important because accounting information is used by investors who make economic decisions by making predictions of future cash flows of company they invested in. For this reason, financial reporting should be understandable, relevant, reliable and comparable as laid by the International Financial Reporting Standard (IFRS). This is an Islamic imperative that all IFIs must subscribe to such that stakeholders can gauge its real value to society.

In financial accounting, a balance sheet or statement of financial position is a summary of a person's assets, liabilities and ownership equity on a specific date, such as the end of its financial year. A balance sheet is often described as a snapshot of a company's financial condition.

A company balance sheet has three parts: assets, liabilities and shareholders' equity. The main categories of assets are usually listed first and are followed by the liabilities. The difference between the assets and the liabilities is known as the net assets or the net worth of the company. According to the accounting equation, net worth must equal assets minus liabilities.

The application of trading and commercial principles (al-bay) in Islamic banking requires banking firms to adhere to financial reporting standard whose purpose is to provide true information of business transactions. For example, when the transaction uses the contract of ijarah (leasing), then the leased asset must be reported in the balance sheet as fixed asset. The purchase of the leased asset is subject to tax whose payment is recorded as operating expense in the income statement. Depreciation allowances are recorded as an expense, thus the company that took the leasing option can benefit from the tax allowances to improve the bottomline. Al-Ijarah thumma al-bay (AITAB) ie leasing with intention to own or buy, is currently a Shariah complaint contract applied for car financing. As specified by the contract of ijarah, the leased asset should be recorded as fixed (ijarah) asset. But when AITAB operates under the conventional Hire-Purchase Act 1967, it (ie AITAB) is treated as a financing activity instead of a true lease as no recording of ijarah asset is evident in the balance sheet.

In asset-financing such as murabaha or al-bai-bithaman ajil contract, the bank is expected to purchase the asset before making the sale. The principle that “one must not sell what one does not own” confirms that the bank must hold ownership of asset prior to sale and thus record it in the balance sheet. Such accounting treatment is an inevitable fact and any Islamic bank that failed this test is guilty of riba since it indicates that no true sale exists. Although bank may hold the asset for a few days or even hours, proper accounting must be uphold.

Financial reporting can prove that a bay al-enah sale is not a true sale but only a fictitious one. Although the aqad approach says bay al-enah is valid (sahih), but not actual sale ever took place since no recording of purchase is evident in the balance sheet. There seems to be a conflict between juristic validity and financial reporting. Such inconsistency suggests that the contract approach cannot stand alone anymore and must find supplementary devices to secure complete Shariah legitimacy.

Legal Documentation of Contract Approach

The aqad Approach primarily pays attention to the fulfillment of the pillars of contracts. Indirectly, rights of contracting parties are defined and made explicit in contracts. The purpose of legal documentation is to

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provide security to contracting parties where their rights, obligations and responsibilities are clearly spelt out in the terms of agreement or contract. The security enabled them to seek legal protection in case the outcome of the contract is not realized as agreed upon in the agreement.

In Malaysia, consumers usually receive legal protection from three legal principles and provisions under: 1) Contractual law: A contract is a legally binding agreement between two parties by which each party undertakes specific obligations or enjoys specific rights of that agreement. In Malaysia, the Law of Sale of Goods 1957 and the Law of Hire-Purchase 1967 provides ample provisions for consumer protection such as passing the asset’s title to the buyer. 2) Law of tort: The law of tort deals with liabilities of the seller. If the consumer suffers injury or harm from the goods sold (ie found to be defective and dangerous) the seller is liable to pay damages. 3) Regulatory (penal) statutes: These affect specific activities that directly or indirectly affect the consumer. They serve to impose standards on goods, services or safety measures by prohibiting specific activities or requiring certain things to be satisfied. Some examples of regulatory statutes in Malaysia are the Price Control Act 1946, Control Supplies Act 1961, Weight and Measure Act 1972, Trade Description Act 1972 and the Direct Sales Act 1993.

Business malpractices (tatfief) can take various forms such as large business organization to monopolize production and kill the competition, misuse of trademarks and patents, sale of duplicate goods by unscrupulous traders, malpractices in direct sales, misrepresentation of cheap sales, misleading price indications, deceptive labeling of products, exploitation and malpractices in housing and real estate transactions. Since the Islamic banking business is no longer confined to financial transactions alone but more importantly the conduct of buying and selling involving possessions and delivery of goods, it is now more exposed to moral hazards commonly evident in the retail and wholesale business. Thus, consumer protection is next in line to be seriously looked at in Islamic finance innovation.

Consumer protection is a form of government regulation which protects the interests of consumers. For example, a government may require businesses to disclose detailed information about products—particularly in areas where safety or public health is an issue, such as food. Consumer protection is linked to the idea of consumer rights (that consumers have various rights as consumers), and to the formation of consumer organizations which help consumers make better choices in spending.

Consumer protection law or consumer law is considered an area of public law that regulates private law relationships between individual consumers and the businesses that sell them goods and services. Consumer protection covers a wide range of topics including but not necessarily limited to product liability, privacy rights, unfair business practices, fraud, misrepresentation, and other consumer/business interactions. Such laws deal with bankruptcy, credit repair, debt repair, product safety, service contracts, bill collector regulation, pricing, utility turnoffs, consolidation and much more. There are many compelling reasons why consumer needs protection. Some major ones are as follows: Poor bargaining position, consumer safety, information gap and advertising practices.

In order to protect the consumers from business malpractices and manipulation, they need to be informed about their rights. The International Organization of Consumer Union (IOCU) outlined eight rights of the consumer, such as 1. Right to adequate product information 2.Right to quality and safety of goods and services 3.Right to choose 4. Right to be heard 5. Right to get consumer education 6. Right to healthy environment 7.Right to redress

The concept of right in Islam lies in the definition of ‘huquq, pl. of haqq. The word haqq meaning “something right, true, just, real”; haqq in its primary meaning is one of the names of Allah (s.w.t), and it occurs often in the Qur'an in this sense, as the opposite of batil (vain, false, unreal). A further meaning of haqq is “claim” or “right”, as a legal obligation. Islamic Law distinguishes the haqq into two kinds: One;

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the rights relating to Allah (s.w.t), and the second; right relating to individuals. The rights relating to Allah are the rights which relate to public interest. They are linked to Allah due to the seriousness of the rights and the comprehensiveness of their benefit. The rights relating to individuals are those which are related to individual interest. Therefore, pardon and compromise is not permissible in the rights relating to Allah while in the rights relating to individual it is permissible.

Under Islamic Jurisprudence, *haqq* is defined as “the exclusive power over something, or a demand addressed to another party which the shari’ah has validated in order to realise a certain benefit”. In Islamic finance, commerce right is confined to something that has monetary value (*qima maliyya*). The concept is confined to rights having monetary value which the law protects i.e. the right of maintenance for dependants, the right to demand wages for work done and the right to demand the delivery of object of the sale upon payment of its price. Such rights are personal and material, as they are designated in the law.

**LEGAL ACTIONS AGAINST ISLAMIC BANKING CUSTOMERS**

The need for consumer protection in Islamic banking can be readily seen from four civil cases involving disputes between Islamic banks and their customers. These cases relate to defaults of *murabaha* facilities and its impact on the defaulting customers. There are four celebrated cases on Islamic banking disputes in Malaysia such as 1) Bank Islam Malaysia v. Adnan b. Omar (Kuala Lumpur High Court Suit No. S3-22-101-91 unreported) 2) Dato’ Haji Nik Mahmud vs Bank Islam Malaysia 3. Tinta Press Sdn. Bhd vs Bank Islam Malaysia Bhd and 4) Affin Bank Bhd vs Zulkifli Abdullah. 39

*Lessons*

There are valuable lessons learned from the cases. In the first case, the customer does not understand the concept of BBA and how it affects settlement of debt outstanding balance. He thought all along that the contracted price under BBA is equal to the cost price of BBA asset sold. In the second case, the customer thought that the facility is based on a buy and sell concept. But it did not appear to be so as no transfer of ownership is evident in the sale since the land is put under charge to the bank. In the third case, the customer has failed to understand the contract he has entered with the bank. He thought it was a loan but the contract is actually based on leasing. Finally, the last case demonstrated the fact that an Islamic bank can freely impose a selling price that surpassed the evils of riba when the customer is required to pay up all unearned (i.e accrued) profits.

The contract of *al-bai-bithaman ajil* or *murabahah* currently forms the basis of almost all Islamic financial products today, both in Malaysia as well as the Middle-east. It forms a component in *bay al-enah*, *tawarruq* and commodity *murabahah* and the sukuk. Although BBA is a sale, does not seem to conform to the Law of Good Sale Act 1957. There is an implied condition that the seller has the right to sell that can readily transfer the title of ownership to the buyer. This implies that the seller must hold legal ownership of the goods prior to the sale.

In the case of Dato’ Nik Mahmud vs BIMB, a true sale is not evident since the transfer of asset title from the sale was not effected as the ownership of land remains with the plaintiff. In the case BIMB vs Adnan Omar, the land is put under charge with the bank which means that the defendant has remained the legal owner of the land over the financing period.

It is important that the rule of ownership must prevail in all sales bearing the contract of *al-bay*. Playing down with this rule can imply violation of the Law of Good Sale Act 1957. However, if the contract is written down to evident a financing agreement rather than a sale agreement, the judge will act on the former and not on the

latter. As Islamic banking and finance in Malaysia is gaining more ground, legal cases may soon involve disputes dealing with takaful and Islamic private debt securities. It is important for the proper authorities to see that civil courts are able to preside prospective cases to come.

**Abandon Housing**

Abandon housing problem usually emerge when housing developers failed to pay their contractors for the work done. Failure to pay up has many reasons including malpractices such as siphoning bank loans (ie. bank payments on behalf of customers) by unscrupulous developers who divert the money to other activities not related to the development of estates or inability to obtain sufficient bridging loan facilities from banks. In the worst scenario, the housing project will fall under receivership while customers are forced to continue paying their monthly installments although the prospect of delivery is close to zero. The victims may end up making two payments, namely bank loans and rentals.

Consumers who buy properties under bai-bithaman ajil financing are not spared from the abandon housing debacle. Although no legal cases have emerged, complaints and grievances are not new in the media. Islamic banks as the selling party should be proactive in dealing with property development as they are responsible to deliver the asset according to the specification agreed upon. However, it is common knowledge that Islamic banks remain to play as financiers rather than a true seller. The same applies to bai-bithaman ajil (BBA) purchases via government financing scheme.

In principle, the BBA sale deals with two party only, namely the bank as the selling party and say, Mr. Yazid as the buying party. But prior the BBA sale, the bank must purchase the house from the vendor/developer. This purchase does not constitute a BBA sale. Existing banking law (BAFIA 1989) does not allow a conventional bank to buy asset for profits. They are not allowed to purchase and sell assets to earn money. In this way banks, cannot buy houses from the vendors. They only provide financing i.e. make loans. The same does not apply to Islamic banking. Civil transactions require the customer to purchase the property from the developer. The Islamic banking Act (IBA) 1983 is a civil law and stays under the jurisdiction of Civil court. It allows Islamic banks to buy property from the developer but only to see the banks refusing to do so. This is because Islamic banks do not want to take the risk. They will incur losses if unable to make the sale.

When an Islamic bank is not keen to purchase the property, it is up to the customer to make the move. In conventional banking, Mr. Yazid will meet the developer/vendor and sign a Sale and Purchase agreement (S&P) after paying a 10% down payment, i.e. $12,000. In conventional practice, Yazid will look for a bank that can lend him the remaining $48,000. Assume that Maybank approves the loan and pay the developer $48,000 on behalf of Yazid. Thus, Yazid gets a loan from Maybank such that he can purchase the property from the developer on cash basis. As a condition Yazid will pledge the property as collateral via the Deeds of assignment on the $48,000 loan. Given interest rate at 4% flat over 20 years, Yazid will pay the bank $38,400 more in interest. His monthly installment = ($48,000 + $38,400) / 240 = $360. To sum up, conventional financing consists of the following contracts, namely, 1. contract of loan between the bank and Yazid 2. Deeds of Assignment/Charge.

The same procedure applies for Islamic banks. When bank refuses to buy the property from the vendor, Yazid buys the property from the developer. He puts up RM12,000 as downpayment to secure the Sales and Purchase agreement on his favour. In this manner, Yazid becomes the legal and beneficiary owner of the property. But how could Bank A sells the property to Yazid via BBA contract when in the first place it does not own the asset? The Holy Prophet says “do not sell what you don’t own”. Bank A must be careful not to violate the above Shariah injunction.

To so do, Bank A must purchase the property from Yazid via the Property Purchase Agreement (PPA). The current practice indicates that the bank pays the customer $48,000, which it passes on to the developer. Once the bank holds ownership via PPA, it then sells the property to Yazid via the Property Sale Agreement (PSA).
Here the terms are as follows: 1) Seller (Bank A) and buyer (Yazid). 2) Object of sale: Low-cost house 3) Price of object: Cost price ($48,000) + profit margin ($38,400) = $86,000. 4) Installment payments = $86,000/240 = $380

Similar with conventional practice, Yazid will pledge the house as a collateral via the Deeds of Assignment or Charge. It says that the bank holds beneficial ownership of the property in the manner that it holds the right to sell it when Yazid defaults the BBA facility.

To summarize, BBA sale consists of three contracts, namely:

3. Deeds of Assignment/Charge: Bank A holds property as collateral.

It seems that the above agreements were drawn to treat BBA as a loan rather than a sale (al-bay’a). In a BBA sale, the bank should purchase the house from the developer/vendor. Sale and Purchase agreement (S&P) should have taken place between the bank and developer. In this manner, the bank will hold risk of ownership (ghorm) and there holds the right to earn profits from the sale.

Since civil procedures require S & P agreement signed between customers and developers, Islamic banks are forced to introduce the Property Purchase Agreement (PPA) to secure ownership (milkiyah) before executing the Property Sale Agreement (PPA). If civil law allows Islamic banks to purchase the property from the developer, then the BBA sale shall consists of the following agreements:

2. Deeds of Assignment/Charge: Bank holds property as collateral.

**Defective products**

The law of torts usually handles the nature of liability held by the selling party. One example is property damages from construction or production defects caused by negligence of the manufacturer. For example, in a bai-bithaman ajil (BBA) financing purchase some defects are found in the houses newly delivered a developer. Should the customer compliant to the developer or should they leave the matter to the Islamic bank as the selling party? In conventional financing, the later is true, but should Islamic banking do the same thing? By virtue of the BBA contract, it is apparent clear that the bank should take responsibility of the damages.

The customer must be informed about their Islamic rights of option (khiyar) in the BBA contract. The right must be exercised by the buyer onto the bank as the selling party and not the developer instead. The issue at hand is khiyar al’-ayb or option of defect. It is about the option given to the customer to cancel or annul the BBA contract when a defect on the goods sold is found. In the BBA agreement, the bank is expected to take forceful action onto the developer for instant remedies to see that the defects are removed. The khiyar al’-ayb or the option of defect is a legal right. This means the customer does not need to stipulate a special clause or provision of the option at the time of contracting. It comes automatically with the BBA sale. According to the Mejelle, “any buyer in Islamic law has an automatic implied warranty against latent defects in the goods purchased”.

The legal documentation approach should be able to spell out what is desirable in the contract approach. Both should be in congruence and do not move in opposite direction. The documentation approach explain the rights and responsibility of contracting agents while the contract approach articulate what the transaction is made of.
CONCLUSION

It is important to see the consistency of form and substance in the four methods explained above. As an example, when it is found that the murabahah/BBA contract is valid via the aqad approach, the financial reporting approach should be able to show that the bank has initially hold ownership prior to the murabahah sale in which the object of trade is recorded as fixed asset for a specific time line in the bank’s balance sheet. Once the murabaha sale is executed, the bank holds murabahah receivables instead. The legal documentation approach should evident transfer of ownership from the vendor to the bank and from the bank to the customer through proper registration of ownership. The sale should grant legal protection to the customer in case the asset delivered was say, defective. Likewise the bank should get protection from the court if the customer defaulted on his murabaha debt obligation. The maqasid approach should provide insights that the murabaha contract does not embrace riba values and lifestyles. If riba, through interest-bearing lending and borrowing is responsible for financial turmoils, murabaha financing is not expected to produce economic bubbles leading to the same. Usually the aqad approach resorts to screen the contract from the explicit contact with riba, gambling (maisir) and ambiguities (gharar) as well as the type of commodities traded. It however may not be able to test say, ownership risk unless it looks into the legal papers of the murabaha facility or studies the bank’s balance sheet. Thus it is imperative for Shariah scholars to recognize the role of legal documentation and financial reporting of the contract to ascertain full Shariah compliance. Likewise, the impact of the transaction on the society should also be acknowledged. This involves incorporating the maqasid al-shariah in the examination of contracts.