HOME FINANCING DECISIONS OPTIONS IN MALAYSIA

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Abstract

The fundamental purpose of this paper is to examine two approaches of home financing option namely conventional housing payment and Bai Bithaman Ajil (BBA) financing in the context of housing market. BBA home financing is an Islamic housing payment facility, which is based on the Syariah concept of Bai Bithaman Ajil or in short BBA. It is a unique contract of deferred payment sale on Islamic home financing. During the 1997 Asian Financial Crisis, home financing activities seems to be deliberately slow as the result of higher interest rates, depressed housing prices, rising unemployment and declining incomes. In addition the quality of property loan was more affected than individual mortgage loan, which proved elastic to external shocks even when credit underwriting conditions were stretched. In Malaysia, the issues of home purchasing processes is seen as a complicated and subjective issues as the rapid urbanization in Malaysia seems have strived developer competing with each other to attract public interest in home financing despite providing alternative attractive packages in order to increase their sales. Here, we look into the concurrent conventional home financing activities offered by the conventional banking system and Islamic home financing offered by Islamic banks. The study carried out descriptive statistics in comparing the two home financing options as well as look through the involvement of government support housing finance agencies.

Keywords: Bai Bithaman Ajil (BBA) financing; Conventional housing payment; Deferred payment sale; Government finance agencies.

JEL Classification Codes: D1; R21.

1. Introduction

Each and every person in this world wishes to own a home. A home is a tantamount purchase that the general public hopes to make by middle age. According to Ahamed and Dzuljastri (2003) having a good home with a comfort place and protection from sun and rain is an aspiration to everyone.

In 1997, when the Asian Financial Crisis occurred, home financing activities seems likes a bit slow as the results of higher interest rates , depressed in housing pricing, hiking in unemployment rate and declining households incomes. Furthermore, the quality of property loan credit was more affected rather by individual mortgage loan, which tends to external shocks as well as underwriting conditions were stretched. Thus both the legal sorority and banking industry were quite alarmed and concerned about this situation.

Nowadays most bankers and financial institutions offer to a homeowner loans, a choice of either a conventional loan or Islamic financing. As a household may questions the differences between these two finance techniques. Basically, the simple answer is that both financing are the same, except in a conventional loan, the purchaser will pay interest and in Islamic financing, the purchaser will pay a profit rate. According to Mike Maguid Abdelaaty, president of American Finance House – LARIBA said that the key difference between Islamic and traditional mortgage is how the rate of return is the interest rate.

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2. BBA concept of house financing

The BBA's concept is popular and widely used in Malaysia. This concept has been approved by Shariah Board which is centered in Central Bank of Malaysia and majority of Islamic Bank in Malaysia. Until December 2005, BBA's concept was used as 52.9 percent in the publication of Islamic Bon (Sukuk) rather than other concept. While during 2005, this concept widely used is about 41 percent in financing customer product. All this figure showed that this concept is extremely comfortable used by Islamic banking in Malaysia. In fact it also popular used in Brunei and Bangladesh (A. Rahman, 2006 - Head, Shariah Coordinator, Asian Finance Bank Ltd).

Simultaneously, the bank sells the property to the customer at a selling price which comprises the bank's purchase price and a predetermined profit margin. The agreement between the bank and the buyer of the house is called the property sale agreement. Since Islamic financing requires a predetermined profit to be made by the bank, a buyer will never have to worry about a sudden hike or changes in the interest rates fluctuation. From the beginning of the transaction process, the buyer will know the total amount which he/she has to pay to the bank and it was acknowledged that the monthly installment of the bank's selling price will not change throughout the term (tenure) of the financing.

BBA House Financing is an Islamic house financing facility, which is based on the Syari'ah concept of Al-Bai' Bithaman Ajil (BBA) (Mohd Nasir, 2007). BBA 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 (Khir *et al*, 2008). Profits in this context are justified since it is derived from the buying and selling transaction as opposed to interests accruing from the principal lent out. All the components to determine the selling price has to be fixed because the selling price has to be fixed at the time the contract is made, Hence, the profit rate for BBA financing is fixed throughout the period of financing (Saiful, 2005).

Thus, under this concept, a seller buyer relationship will be established and the selling price is fixed upfront. The sales price is then repaid in periodic installment and the agreed installment will remain fixed throughout the financing period. As such, customer's interest rate risk is eliminated. Furthermore, arrears will not be capitalized (Salahuddin, 2006). Normally for house or residential property financing, the maximum repayment period is 30 years or at the age of 65 whichever is earlier. It might differ from one Bank to another (George, 2003). The sales purchase process will take place as follows:

Table 1: BBA contract flow

(1) Customer notify the related assets to the bankers (2) Financial institution buys the related assets form the assets' owner (3) Financial institution sell backs the assets to the customer with mark up price agreed by both parties (4) Customers pay at sales price by monthly installments to the financial institution

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Characteristic of a loan

Purchasing a house can be a valuable form of investment. However, it requires considerable thought and careful financial planning before taking on such a big step. Most people take on a housing loan from banking institutions which offer different loan packages to cater for the needs of different users. Different financial institutions have different criteria in calculating the repayment capacity. In calculation of a loan basically it is based on the payment of interest, the tenure of the loan and the margin of financing of loan.

Margin of financing
The amount of financing provided by a financial institution depends on the market value, for the completed properties only or purchase price of the house, whichever is lower. Basically the margin of financing could go as high as 95 percent of the value of the house. It is assessed on factors such as type of property, location of property, age of the borrower and income of the borrower.

Loan tenure
The length of a loan can range anytime up to 30 years or until the borrower reaches age 65 or any other age as determined by the financial institution, whichever is earlier.

Loan features
As we mention before, each financial institution packages its housing loans differently. Therefore as a buyer of house should examines all the features of a loan package. Pricing is just one consideration but other features like repayment terms could balance the scale or even translate into greater loan savings.

However, in some case, the close relationship between bank and customer, make the bank willing to finance their loan. In this situations, it is depends on the trustworthy. Jimenez and Saurina (2002) studied the impact that certain characteristics of loan (i.e collateral, maturity, size, type of lender and closeness if the customer-bank relationship) have on default rate or credit risk. They found that when a bank has a strong relationship with a particular customer or exclusive relationship, the bank is more willing to finance higher risk projects. It also showed that the marginal impact of each characteristic of a credit operation on probability of default (PD), highlighting the utility that this can have for a banking supervisor interested in off-site monitoring of credit risk or in an improved allocation of scare resources when carrying out the necessary on-site monitoring.

3. Literature review

Statistically, BBA's concept is popular and widely used in Malaysia. This concept has been approved by Shariah Board which is centered in Central Bank of Malaysia and majority of Islamic Bank in Malaysia. Until December 2005, BBA's concept was used as 52.9 percent in the publication of Islamic Bon (Sukuk) rather than other concept. While during 2005, this concept widely used is about 41 percent in financing customer product. All this figure showed that this concept is extremely comfortable used by Islamic banking in Malaysia.

In fact it also popular used in Brunei and Bangladesh (Rahman, 2006) as compare to the conventional loan whereby the customer will repay to the bank the loan amount, together with interest at the agreed rate. The rate is based on a margin above the bank's base lending rate (BLR), and normally, the both margin and the BLR are variable from time to time. In a case of late payment or default of the buyer, the bank is entitled to charge compound interests. Interest payable may also be capitalised and the capitalised amount will be subject to further interests.

Ever since the principles of Islamic finance were laid down in the Holy Qur'an 14 centuries ago, the development of Islamic financial institution has undergone a severe challanges of ups and down and only during the final chapter of the 20th century that people can see the global network of Islamic banks and other financial institutions started to take shape (Abdul and Norizaton, 2000).

In Malaysia for example in 1983, there was only one bank that provides Islamic financial product but now almost all local bank commercial banks provide Islamic financial windows. The basic difference between Islamic and non – Islamic banks lies in the fact that the former operate on an equity participation system in which a predetermined rate of return is not guaranteed, whereas the latter's operation is based on both equity and debt systems that are driven by interest. Therefore the researcher tried to examine Islamic Banks's strategy in educating the public about their existence and products. One of the products is Bai Bithaman Ajil (BBA) product and they found that 21.5 percent of people knew about existing of BBA, 75.2 percent did not know about the product and 3.3 percent was no responds.

Saiful, Mahmood and Norhashimah (2000) in their paper argued that the application of bai-bithman ajil contract in Malaysian Islamic banks seems that overlook the requirement of 'iwad. According to them, theoretically, in a BBA sale the bank as a seller must be liable for any product defect and the ensuing compensatory damages. The option of defect (Al Khiyar al-Ayb) is operative once the goods are sold, which the bank must honour in order to claim legitimacy on the profit made. As a conclusion, based on the given rules on Khiyar ‘Ayb, it is apparent that an Islamic bank as a selling party must hold all liability arising from all defective goods sold. But in practice, as shown in the respective legal documentations, it is evident that the bank holds no such liability. Furthermore, an Islamic bank that practices Bai-bithaman ajil seems to only champion its right without conferring duties of equivalent values to the buying party. In fact, it has transferred relatively all the risk and liabilities to the customer thereby leaving it.

Prior to 1997, the absence of banking regulatory support meant that all US efforts to provide Islamic home finance have been ad hoc and capital constrained. To a lesser degree, they have limited integration to either shari’ah scholarship or the international Islamic capital market.

According to Thomas (2001) although a major international bank worked with both a US mortgage bank and a key Islamic bank to structure an Islamic home finance program as early as 1993, no formal regulatory framework or authorization existed for a such program prior to 1997. Once the Office of the Comptroller of the Currency (OCC) granted authorization and later approved installment sales with bank taking title to property as a banking instrument in 1999. The rulings upon a series of common factors, first the regulators examined the bank request and evaluated its similarity in risk and purpose to existing banking powers and secondly the regulators reviewed whether or not the interpretation would result in making banking more inclusive. This conclusion allows regulators, vendors and investors, including banks and agencies all to find it reasonable to examine in the newly emergent product class.

As financial markets move toward increased globalization, it becomes worth considering whether inherent differences in financial markets across different countries will diminish. On the other hand, Courchane and Judith (2001) examined some of the differences in policy and in competitive practices between Canada and the USA in an attempt to illuminate why differences in rates and terms across the two countries still exist. They found that despite similar homeownership rates, the structure of the mortgage markets, the public policy objectives, the rates, terms and products of mortgage instruments all substantially differ across the two countries. Those disparities do not appear to result from differences in the demographics affecting housing demand across the two countries. As a result, they found that many of differences came from the public policy objective across the two countries. In US, the longer term loan practices led to interest rate risk being shifted to the global market with the development of mortgage securitization, there was no such need in Canada as borrowers did not have the power to influence the government to follow the US route.

Furthermore, Canada has often used homeowner incentives schemes, rather than affecting outcomes through policies on the supply side. In addition, the factor leading to substantially different product across the two countries is likely the relatively concentrated primary mortgage finance market in Canada. Meanwhile there no particular incentives for banks to move toward any products as favorable to borrowers as those most typically preferred in the US.

Seko (1993) presented a microeconomic model of Japanese housing demand focusing on the Japanese home financing system. The emphasized the tradeoff between housing quality and quantity by analyzing the user cost of capital of owner-occupied housing for several different sub samples. The unique features of the model are the nonlinear budget constraints. Besides that, this research executed reduced form estimation on the composite housing demand model and the characteristic housing demand model. The result showed that the price and income elasticity of composite housing demand are approximately -0.74 and 0.60 respectively those floor demand are -0.13 and 0.31, respectively and those of quality demand are -0.67 and 0.49, respectively. Estimation result also indicate that housing demand by non JHLC borrowers is more price elastic and more income elastic for composite housing demand and floor demand, but JHLC borrowers are more price elastic for quality demand. The paper derived about 328,000 yen per household in 1986 yen for housing quantity and 38,500 yen for housing quality based on a characteristic housing demand model.

Another researchers Davies, Gyntelberg, and Chan (2007) examined the role of government supported housing finance agencies in Asia. They estimate the size of the government subsidies received by these agencies and their distribution among households, financial institutions and the agencies themselves. As a conclusion they founded that in Asia, government supported housing finance agencies have played a constructive role in the development of domestic residential mortgage and bond markets. In most countries, they have not required large government subsidies, for example in all countries except Singapore, the level of government support is below 0.1% of growth domestic product (GDP). The housing finance agencies have also managed to transfer most of the benefit of their government support to either households or financial institutions. However, in Japan, one of most reasons why the GHLC's role was refocused away from direct lending towards supporting securitization of mortgage originated by private lenders. Here the risk is that the government subsidized housing agencies will distort competition, crowd out private lenders and mortgage insurers, and ultimately hinder market development.

Ariccia, Igan and Laeven (2008) observed the current sub prime mortgage crisis to a decline in lending standard associated with the rapid expansion of this market. As a result they found that the recent rapid credit expansion in the supreme mortgage market was associated with easing credit standards and the current troubles in this market are more severe in the areas where the expansion was faster. There are three conclusions in lending standard, firstly, the rapid credit growth episodes tend to breed lax lending behavior. Secondly, lower standards were associated with a fast rate of house price appreciation, consistent with the notion that lenders were to some extent gambling on a counting housing boom, relying on the fact that borrowers in default could always liquidate the collateral and repay the loan. Third, change in market structure mattered, lending standards declined more in regions where (large and aggressive) previously absent institutions entered the market.

4. Government and BBA financing

Property was hot in Malaysia in the early 1990's with two particular peaks – in 1991, when a 26 percent year of year real price growth was achieved and in 1995, with 18 percent real price growth. After the Asian Crisis hit Malaysia, the average price declined during the economic slowdown. Before 1997, the price increased could be as a result of high demand and increased cost of construction materials and labour. Furthermore, the demand for houses was also supported by the ready access to financing. However the price of low cost houses for the low – income groups remained relatively stable because of the price control imposed by the government. Until beyond 1998, the demand for low cost still maintain because the continuous government support to help these low-income target groups.

Government need make some radical changes radical in the issue of housing. The duty of government is to provide house to the people and take seriously on the human well fare in such country. Yet there are still many things that should be improved. In Malaysian contexts, there are public and private agency which is established and able to help people in order to get an information and always available to support buyer in buying a house. They are Ministry of Housing and Local Government, Cagamas Berhad and National house buyers association.

Government indeed catered some essential changes when addressing public housing issue. The government role is to facilitate and provide better fundamental housing development regulations and balance financing mechanism in order to overcome public interest and developer mission of providing more affordable housing estate.

The Prime Minister Department indeed addressing the prominent issues when come to buying a house whereby the department advised buyer to at first studying the condition of purchasing a house, whereby the developer should complete their house before selling them out to the buyers. The concept of 'build then sell' ever voice out by society when the buyer often experienced with the problem the house not complete and dissatisfied in design. This is because they just rely to the advertisement, a great promotion and sweet promise from the developer. The call by the PM for developers to build houses first before selling them should be lauded.

According to Communication Director, Mohd Yusof Abdul Rahman said that they know that the application of this method will causes to the price of the house from 10 percent to 20 percent but it still can accept by the buyer because their satisfaction of the quality of the house build. He says, buying a house is a huge investment and it only made once in a life. Therefore a buyer of the house, they anticipate for high ranking houses and may not be any problem occurs in the future. Nowadays, the concept 'sell and build' just give advantage to developer. The buyer just waits and imagines their future house with uncertainty till the house completed (Berita Harian, April 7, 2008). He responds to the possibility the bank refused to fund the project 'build and sell' he says housing project is a potential and highly return and bank should not afraid to finance their financing.

Moreover, he adds the government should play their active role if the representative bank refuse to fund the project with (1) create a housing fund to smooth/ help project at an early stage as a security on the bank side, (2) or give land to developer without purchase the land first to build the house in other words, the developer build the house without prior purchase land from the government, and (3) to boost and monitor the architect and engineer appoint by government instead of appoint by the developer to ensure the work done is transparent.

5. BBA and conventional loan data

In order to compare the allocation of housing loan between BBA home financing and conventional home financing, we get through a set of home financing data form four major banks operated in Malaysia. Two banks are representing major BBA home financing data from the annual report another two banks representing the conventional home loan gathered from the annual report. Table 1 below illustrates the BBA financing between Islamic Bank 1 and a Commercial Bank 1 with the range of BBA financing data of 2000-2006. From the table it was justified that when come to BBA financing activities, public tend to prefer an Islamic Banking procedure in carrying out the respective load.

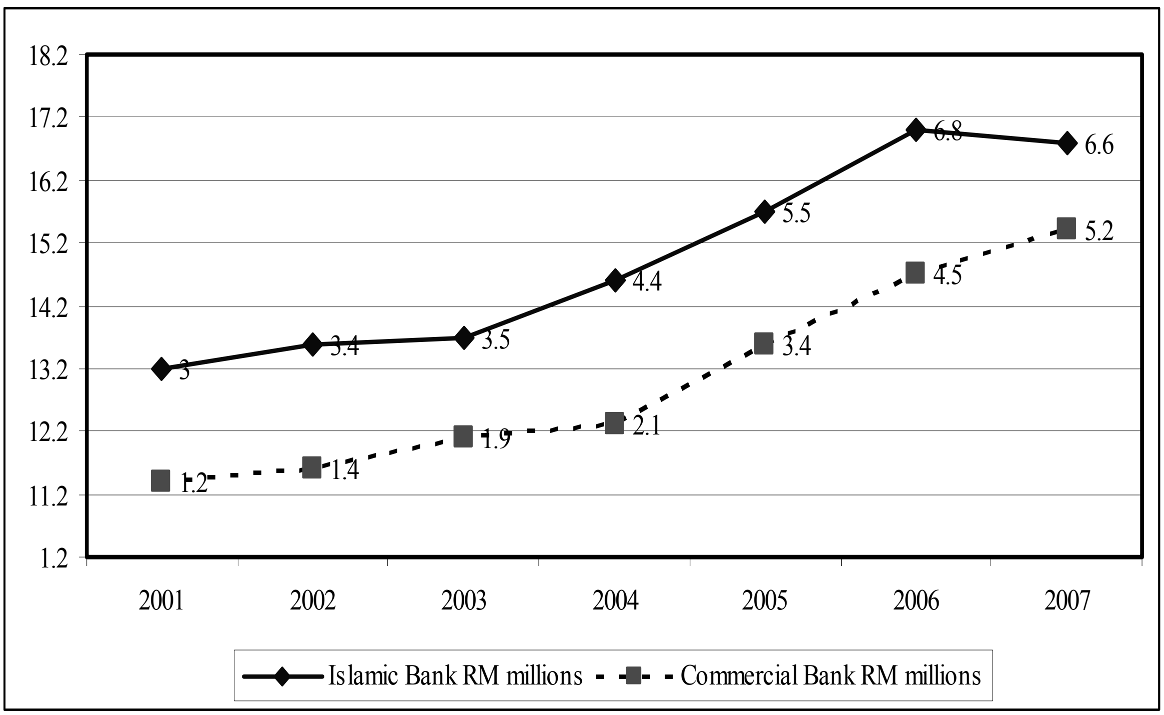
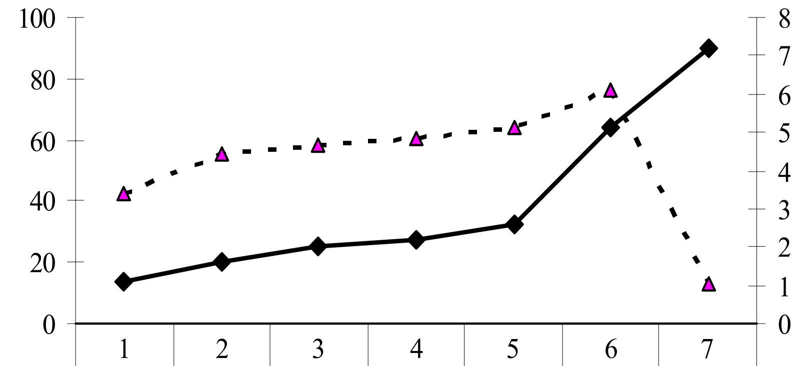


Figure 1: BBA financing table from Islamic bank and BBA financing of commercial banks
Source: Various Banks Annual Report (2008)

Figure 2 however representing the conventional loan portion of the housing financing between two major commercial bank, namely Commercial Bank 1 and Commercial Bank 2 within the range of loan allocation data of 2000-2006.



	1	2	3	4	5	6	7
Commercial Bank 1 RM millions	42.1	55.2	58.1	60.2	64.1	76.6	12.8
Commercial Bank 2 RM millions	1.1	1.6	2	2.2	2.6	5.1	7.2

Figure 2: Conventional home financing value between two selective commercial banks
Sources: Various Banks Annual Report

Both Table 1 and Table 2, showed that BBA finances either in Islamic Bank or Commercial Bank obviously indicates the distinctively arise the awareness among Malaysian public in choose BBA housing financing offered in the market. Thus, it is also showed that BBA financing increasingly preferable among buyers as well as conventional housing loan.

6. Recommendations

Recently issues arise and debate on whether the housing industry should adopt the 'build and sell' concept. Prime Minister Datuk Seri Abdullah Ahmad Badawi has said it was not right that house buyers have to pay before they can get their houses. His worry was about the people who had paid for their houses but later found their project abandoned. He wanted developers to have adequate funds in hand before embarking on housing projects and 'not sell first to get the money to build'. He said that consumer advocates are, of course 100 percent in favour of the concept because they think it could solve most, if not all of the problems that have convince Malaysian house buyers, including late delivery of houses, substandard workmanship and abandoned housing schemes.

Housing developer, however are adamantly opposed to the concept because the current 'sell and build' system favours them in every imaginable way.

Nevertheless, bankers and economists, warn that the adoption of the 'build and sell' concept could be injurious to the interests of house buyers as it would almost certainly raise the purchase price of new houses.

In actual fact, the idea of making it compulsory for developers to build houses before they sell them has been around since Tun Abdul Razak' time, but developers have always argues that the housing industry is not ready for such as major paradigm shift.

Real Estate and Housing Developers' Association president (Rehda) Datuk Jeffery Ng Tiong Lip claimed that the build-then-sell concept still need several factors that can affect sustainable growth and the national objective of home ownership are ironed out. Firstly, the level of maturity that the build-then-sell concept to be implemented immediately. Malaysia needs between 100,000 and 150,000 new of houses each year. The adopting of build-then-sell concept will result in a significant reduction in housing production and market players and this could lead to potential severe social and economic implications. Secondly, developers would have to seek project loans instead of bridging finance and the financial institutions would lend if they could not gauge the viability of the projects.

Moreover, he said that , the banks have been known to be reluctant to lend when conditions are not risk-proof. "*Even under the present 'sell and build" system where developers can demonstrate viability based on sales, banks have been known to be reluctant to lend when conditions are not risky*" said Ng. He believed that build-then-sell concept is not relevant in Malaysia but need to be further explored through discussions with all relevant parties, including the Finance and Housing and Local Government ministries, banks and some industries which are directly and indirectly linked to the industries. Ng also stressed that the build-then-sell concept can improve Malaysia economic of scale throughout builds phase by phase unit of houses same system which is widely practiced in Australia, United Kingdom and United States.

After all, we concluded that:

Buyer

- The buyer should do research before they decide to buy a house.
- The buyer should survey all banks which offer conventional and Islamic loan.
- The buyer should investigate the developer before they make a deal with.
- The buyer should know their right and obligation as buyer to such loan they going to borrow.
- When the buyers default in payment, actually the default is not from the buyer but from the institution which is handle the payment made. So as the buyer, must check from time to time the payment transfer directly from their account so that the payment will be not delay.

Developer

- The developer can choose any concept which they are prefer, but they must put the priority to build house which can make profit to them and avoid the abandoned house.
- The developer must put inside inculcate attitudes and try to avoid indemnity to the environment and ensure greenness still protected.
- The developer can manage well their fund and try to utilize their budget in housing project. They should have a 'petty cash' in their planning management.
- The developer can build the house based on the customer satisfaction. Therefore, they can avoid the losses at a minimum level.
- Same with the buyer, the developer should plan their research and development well before they decide to involve in housing project.
- At early stage, developer can build housing unit in small quantity with the basic perfect community facilities such as mosque, playground and 'balai raya'.
- Try to maximize the benefit they have for example collection of 10 percent from the price of the house give the developer benefit to start their project as promise to buyer and at the specified date.

Bank

- House financing can create greater revenue to bank. However the bank must give loan with minimum rate and not burden the buyer. The rate plus Base Lending Rate (BLR) must in minimum rate so that the buyer can manage their saving well. At the same time, the bank can minimse their credit risk and reduce their non performing loan (NPL) which can affect the bank in future trading. Besides, the bank which can manage their credit liquidity well can make another profit and fund their profit to finance other project.
- The bank can make investigation on the future customer in term of their ability to make a loan; therefore bank can minimize their default risk of buyer. Normally, the buyer who has close relationship with the bank has advantage whereby the bank is willing to lend to them without any restrict application.

- When the buyers default in payment, actually the default is not from the buyer but from the institution which is handle the payment made. Bank which is responsible to pay to developer must make sure the payment will be not delay.
- Set up a department, division or specialization to handle all the subject matter relates to lender.

Government

- Establish act which is more friendly for example if the home built cannot finish at the specified date, the buyer can collect 50 percent from the sales price.
- The Central Bank of Malaysia (Bank Negara Malaysia) acts on behalf government as a lender of the last resort can give fund and moral support to commercial bank, merchant bank and Islamic bank to finance fund.
- Make a plan and target the specified areas that can be used as a means of national development. For example, need a suitable place which relate to the demand of the buyer of a house.
- Land is a profitable investment of real estate which may gain higher return in long term. Therefore, government can give a lower price as well as an incentive to the developer to finance the project.
- They can also monitor the activities done by developer form time to time until the house is completing build. The government also can give rating to the excellent developer and give benefit to the developer as well (The Star, 13/04/2008).

7. Conclusion

As a conclusion, it is an essential decision in buying a house, the buyers should be more aware in evaluating and makes fundamental firm decision housing financing offered in the market. It is not only concerned with of suitability loan options, but as well as choice the right financing tools that can provides them with maximum satisfaction of housing services and products. Thus, it is up to the buyers to make their own decision to charter with either conventional financing mechanism or applied to BBA financing approach offered by merely Islamic banks or other commercial bank which also offered the BBA term of housing financing facilities.

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