

Islamic Property Financing in Malaysia: Critical Appraisals and Practical Recommendations

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Abstract

Apparently, Islamic Banking and Finance system in Malaysia in particular Islamic Property Financing is one of the most established Islamic Property Financings in the world. However, most of its salient characteristics are almost similar to the conventional property loans whereby most of the significant terms are just changed to Islamic based terms and aqad or contract is executed in order to make a property financing become Islamic. Truly, the issues that must be taken into account not only aqad and terms but they are much more than that. These irregularities exist owing to mismatch of knowledge and experience between the management of Islamic financiers and the Islamic scholars who sit on the Syariah Advisory Board of the Islamic financiers. In this article, critical appraisals and analysis is executed on the salient features of an Islamic Property Financing namely Syariah Perspectives, Ownership Transfer and Legal Documents, Profit Charged and Installment and lastly Redemption and Early Settlement. Subsequently, practical recommendations to improve the Islamic Property Financing in Malaysia are suggested so as to endeavor for a more comprehensive Islamic Property Financing that is in line with Islamic Syariah regulations which could assist customers to purchase properties yet could still contribute profits to the Islamic financiers/banks.

Keywords: Islamic Property Financing, Malaysia, Ownership, Syrah

Introduction

Obviously, the establishment of Bank Islam Malaysia Berhad in 1983 had paved the way for the continuous development of Islamic Banking and Finance in Malaysia. Throughout the years, Islamic Banking and Finance in Malaysia has been undergoing numerous changes and enhancements which has positioned Malaysia as one of the top countries globally that implement and support Islamic Banking and Finance system. Likewise, Malaysia is also one of the top global centers for the development of Islamic Banking and Finance research and education. Malaysia is fortunate as the former and present administration is in consensus to further develop Islamic Banking and Finance in the country. Nevertheless, there are some loopholes in Islamic Banking system and practice in Malaysia from Syariah perspectives which have not been rectified since the day one of the system's establishment till to-date. The problems arise since there is a mismatch of expertise between management of Islamic banks and the scholars/experts who sit on the Islamic banks Syariah Advisory Board. Most of the said management is not well-verse with Syariah teachings on Islamic Banking and Finance theories whilst the banks' Syariah Advisory Board members do not have sufficient practical banking experience. The issue is not only confined as to whether particular financial products are contractually valid but other imperative factors are also needed to be further analyzed as well as be further enhanced. For example, is it permissible to charge profit rate that is based on floating rate namely Base Financing Rate and many more. In this article, a thorough analysis is conducted on issues with regards to Malaysian Islamic Property Financing together with practical recommendations to improve the system.

1. Syariah Perspectives

1.1 Appraisals: Islam encourages trade and business but strongly prohibits usury or riba' as per part of a verse in Quran: "And Allah permits trade but prohibits riba'" (Quran, 2:275). In Islam, there is only one type of loan namely Qardhul Khasan (Benevolent Loan) whereby no interest charged by a lender on the loan amount but a borrower could voluntarily give additional amount to the lender as a gift/hibah to appreciate the lender's assistance and kindness. The real intention of Qardhul Khassan is to help the borrower which is in difficulties and thus need of assistance.

However, most of Islamic scholars in Malaysia opined that Islamic financiers could charge administration as well as processing fees in order to cover their administration fees and expenses. In Malaysia at present, a lender is allowed to charge nominal amount as a processing fee for a loan transaction in line with the decision of Malaysian Fatwa Council to allow 1% processing fee charged on the study loans provided by National Fund for Higher Education or Perbadanan Tabung Pendidikan Tinggi Nasional (PTPTN). This is to cover the processing fee and administration fee that incurred from the loan application till full settlement of the loan.

On the contrary, at present, the ultimate and real target of all Islamic banks in Malaysia is profit and not really to help the borrowers that need financial assistance. Their main target is profit maximization through increasing their market size. They are also competing to increase their assets in Islamic loans in tandem with higher demand as it was proven that Islamic banking and finance has been less affected by 2007 economic turmoil as against conventional banking and system. Further, some borrowers prefer Islamic loans/financings due to their better packages that could alleviate a number of costs namely minimal/no overdue charges, no commitment fee on Islamic Cash Line (Islamic Overdraft), fixed Selling Price just to name a few. If a property financing is based on trade i.e sell and purchase transaction, it is deemed encouraged in Islam. However, the property financing packages in Malaysia that are claimed as based on trade is not really a trade transaction but merely a financing that almost resembles conventional property loan. For instance, a property financing which is claimed as based on Ijarah or rental concept is not really a rental transaction since the real ownership of a property in the Ijarah arrangement is not belong to an Islamic financier as a Landlord.

Furtherance, the same situation applies to other types of Islamic Property Financings which are claimed as based on trade namely Bay' Al-I'nah or Bay' Al-Bithamin Ajil. The underlying property in Bay' Al-I'nah is originally owned by the Islamic financier and then sold to a customer with payment on installment basis. The customer will sell the property to the Islamic financier at a lower price. In actual fact, the property is not legally transferred to the customer as there is no Sales & Purchase Agreement (S&P) signed between the 2 parties except Asset Purchase Agreement (APA) and Asset Sale Agreement (ASA). Moreover, the necessary procedures to transfer the said ownership are not executed at the authority office like Land Office and many more. The APA and ASA are merely executed in order to make the transaction appears as a trade transaction. Likewise, the same arrangements and situation imply to Islamic Property Financings under Bay' Al-Bithamin Ajil packages.

In Islamic Property Financings in Malaysia, the Islamic financiers never take any risk of property's non-completion or other types of risks since the S&P is only signed between a developer/vendor and a purchaser or customers of the Islamic financiers. In other words, the Bank is making profit without to bear any risks on the property to be financed. Moreover, as highlighted earlier, there is only one type of loan that is allowed in Islam i.e Qardhul Khassaan. However, current Islamic Property Financings in Malaysia are very similar to the conventional property loans but with different terms and terminologies. Apparently, the said Islamic Property Financings are also not trade/sale of property from the financiers to customers since the Islamic financiers do not really buy a property and sell the same to their customers. These are loans with *riba'*/interest and *gharar* elements. A transaction or *aqad* will be haram or not according to Islamic *Syariah* even if an element of *riba'* or *gharar* only constitutes about 1% or less than that. There must be strong determination to develop a system that is fully based on *Syariah* in order to ensure justice and assistance for customers all as well as to gain profit with regards to the Islamic financiers. In the remaining parts of this paper, practical reviews on the existing practices of Islamic Property Financings in Malaysia including recommendations for a better Islamic property financing are proposed by the writer so as to ensure adherence to *Syariah* principles as well as profitability and survival of Islamic financiers.

2) Ownership Transfer and Legal Documents

2.1 Appraisals: As per current practice of most Islamic financiers in Malaysia, public is in perception that the Islamic financiers buy a property from developer and then the property will be sold to customers by the bank at a higher price. Nevertheless, in actual fact, the Islamic financiers do not buy the property from the developer as the ownership transfer is only from developer to the purchasers or customers of the Islamic financiers. No S&P and transfer of ownership in land title or any other related documents are signed between the developer and the Islamic financiers. This is a loan arrangement as the property will be charged to the Islamic financier and not a trade or sale of property. Therefore, the Islamic financiers do not face any risks for the part of purchasing from vendor/developer.

All Syariah councils of the Islamic financiers approve the documentation of Islamic property financing on the basis that APA and ASA are signed between the Islamic financiers and their customers i.e there is an 'aqad in the transactions. In this existing arrangement, the customers sell a property that he/she has purchased from a vendor/developer to the Islamic financiers for instance at RM100K. Subsequently, the Islamic financiers would sell back the property to the client at a higher selling price for example at RM200K which is payable on installments basis under concepts of Bay' Al-I'nah or Bay' Al-Bithamin Ajil. Under Bay' Al-I'nah, the underlying asset would be the Islamic financiers' asset which could be of any type of assets whilst under Bay' Al-Bithamin Ajil, the underlying asset would be the property that has been purchased by a customer.

In the above existing arrangements, both 'aqad or contracts under APA and ASA are executed simultaneously and there is no payment from the Islamic financier to the customer when it buys the property from their customer. Apparently, the customer who has purchased the property has not fully settled the purchase price of the property as per the related S&P. He may have only paid 10% or 20% of the purchase price and the remaining balance of the purchase price in S&P is yet to be paid to the developer or vendor. Therefore, how the purchaser could sell a property that is yet genuinely and legally belongs to him/her. The execution of APA and ASA is just to legalize Islamic property financing documentation in Malaysia but essentially, it is not a trade of property between the Islamic financiers and their customers. If it is really a trade of the property, the ownership transfer and legal documentation cannot be different from the documentation for normal sale and purchase of property in Malaysia. Thus, the APA and ASA is merely cosmetics to make the Islamic property financing is a trade but it appears that, it is similar to conventional property loan but of course with change of terms and names such as from "loan" to "financing", "bank" to "financier" just to name a few.

2.2 Recommendation

Since Islam only allows trade and Qardhul Khasan, the only alternative for conventional property financing is selling of a property from the Islamic financiers to their customers. A customer that is interested to purchase a property would approach an Islamic financier and give details of the property to be purchased such as developer's name, price, location and many more. The Islamic financier could request for a deposit sum (maybe 10% of the selling price of the property) to be paid by the customer and it is refundable after taking into account all necessary costs that incurred by the Islamic financiers if the customer cancel the purchase in the future. The Islamic financiers would sign an S&P with the developer/vendor and the full selling price of the S&P would be fully paid by the Islamic financier after certain period that is agreeable by both parties as mentioned in the S&P. Subsequently after the selling price fully settled by the Islamic financier, application to change of landowner's name must also be submitted to Land Office to reflect the ownership transfer. After presentation number issued by the Land Office for the ownership transfer, the Islamic financier would sell the property to the customer at a higher price which would be payable in installments for a certain fixed period.

Similarly, an S&P would be signed between the Islamic financier and the customer but the installment's last period would be the expiry period of the S&P since the purchase price would only be settled after that period. However, the customer has the option to settle the purchase price earlier with a gift or hibah. APA and ASA would also be signed between the said 2 parties but the application to transfer the landowner's name cannot be presented yet to the Land Office given that the purchase price has not been settled in full by the customer. The transfer application would be presented to the Land Office immediately after the full purchase price be settled by the customer. Prior to full settlement of the purchase price of the property from the Islamic financier, the property will be rented to the customer by the Bank and all relevant terms and conditions on the rental would be spell out in the S&P, APA, ASA and other related documents. Any single payment towards the interim rental arrangement will be used to deduct the Selling Price. Should the customer unable to repay the installments in the future, the Islamic financiers always have the right to vacate possession of the property or to sell the property. Nevertheless, there must be ample reminders and negotiations between the Islamic financiers and the customer since the prior *objective* of the financing is to assist customers and not to oppress them. If a customer informs that he/she unable to pay the installment that was agreed earlier and he/she requests for lower amount of installment, the Islamic financier should consider the said requests in order to ease the customer's burden as well as to ensure continuous repayment of the financing until full settlement. The tenor of the financing will be lengthened accordingly and if the revised installments and tenor will change the Selling Price, a Supplementary Letter of Offer, revised APA and ASA will be signed between the Islamic financier and customer.

3) Profit Charged & Installment

3.1 Appraisals : The methods used in deriving profit amount for Islamic property financings in Malaysia is identical to the methods used in getting interest sum for conventional property loans. In general, calculation of profit rate is based on Time Value of Money (TVM), Net Present Value (NPV) and many more. A financing with a short tenor would have a lower total profit amount as against a financing with a longer tenor. For instance, a RM100K financing with ten-year tenor and 8% profit rate may have an installment of RM1,200 per month and the total profit amount is RM44K. Meanwhile, a RM100K financing with 8% profit rate as well as twenty-year tenor would have a lower installment of RM900 per month and the total profit would be RM116K. The total profit amount on Islamic Property Financing is based on tenor and the longer the tenor, the higher amount of total profit incurs. Obviously, based on current practice in Malaysia, the formula used to derive a Selling Price for an Islamic Property Financing is produced by multiplying the monthly installments amount with the period of the financing i.e number of months. For instance, an Islamic property financing has a Purchase Price of RM100K and the profit rate is 5% with 120 repayable installments. The installments per month is RM1,061 and thus the Selling Price would be approximately RM127,320 (RM1,061 x 120). The Selling Price is determined after getting installment amount first; and not the other way around. Obviously, the existing Islamic Property Financing in Malaysia still involves elements of interest or riba' on the calculation of instalment amount and Selling Price.

Furtherance, the Islamic financiers in Malaysia also uses Base Financing Rate(BFR) in their property financings that are offered on variable profit rate. BFR is actually similar to Base Lending Rate(BLR) that has been used by conventional banking industry in the whole world. By using BFR in their property financings, the Islamic financiers in Malaysia are indirectly consent for element of gharar (uncertainties) in their property financings schemes given that BFR rate is not fixed (could surge and plunge at anytime) and subject to monetary policy of Bank Negara Malaysia(BNM) which is highly dependent on economic and political developments. Though there is a fixed ceiling price which is capped at a maximum Selling Price, usage of floating rate i.e BFR is not tolerable in an Islamic Property Financing that really adhere to Syariah principles.

3.2 Recommendation

As proposed earlier, the Islamic property financing i.e trade of property from the Islamic financiers to the customers is purely on buying and selling of the property whereby no elements of interest or riba' as well as gharar. Based on Al-Bay Bithaman Ajil, the Selling Price is repayable on installments basis whereby the installment amount is calculated after dividing the Selling Price with the number of future installments. The Selling Price is firstly determined after the Islamic financiers add a profit amount to the Purchase Price of a property. For instance, a customer approaches an Islamic financier and gives the necessary details and information to purchase a property worth RM100K. Assuming after necessary evaluation by the Islamic financier and mutually agreed by both parties, the property will be sold to the customer at RM140K with 120 installments. Thus, an S&P agreement will be signed between both parties with a Purchase Price of RM100K and a Selling Price of RM140K. The installments amount will be RM1,167 per month i.e the Selling Price of RM140K is divided with number of installments of 120. (All other details will be as per aforesaid recommendations in 2).

Therefore, there is no riba' elements in the aforesaid arrangements. Nevertheless, the Islamic financier will be allowed to charge minimal overdue charge or administration charge on any late payments so as to cover phone reminders as well as mail reminders to remind the customer on the late payment. These types of follow-up expenses must be charged so as to ensure profitability of Islamic banks and financiers but in accordance with Islamic Syariah. Under these arrangements, the customers could know clearly how much has been repaid and what is the balance of the Selling Price. There are no other hidden charges except the recovery or follow-up expenses.

4) Redemption and Early Settlement

4.1 Appraisals : Based on practice of the existing Islamic property financings, when a customer decides to settle his/her loan earlier or he/she decides to sell the property or to refinance the existing financing with other banks/Islamic financiers, the Islamic financiers will inform the customer the redemption sum to be paid based on their computerized financing systems. The redemption sum is normally derived after the Selling Price minus a rebate amount or Ibra'.

This redemption sum is normally higher than the actual balance of property financing that remains unpaid i.e higher than the amount of Selling Price minus installments sums that have been paid plus the necessary minimal administration costs.

Moreover, the redemption sum for a property financing that use BFR as its base profit rate will be uncertain and contains elements of gharar since the property financing's Selling Price and repayments are based on a ceiling profit rate which is way higher than the prevailing profit rate that is charged for the property financing (assuming BFR is at all time lower prior to the redemption). Though an Islamic financier will give rebate or *ibra'* on the redemption sum, a customer might end up paying higher amount of installments that he/she should pay since the installment amount is calculated by using the said ceiling profit rate. Likewise and as mentioned above, this redemption sum will be higher than the actual balance of property financing that remains unpaid by the customer. Under existing arrangements in Islamic Property financing, a property under financing that is charged to an Islamic Financier will be discharged and will be re-charged accordingly i.e will be charged to other financiers if refinanced with other financiers or banks. This arrangement is also deemed indistinguishable to the conventional property loans' arrangement. It appears that, these arrangements are not trade transactions since in the most arrangements, the ownership of the properties are permanently belonging to the borrowers or customers of the Islamic financiers.

4.2 Recommendation

With regards to the illustration in 3.2, if the customer decides to sell the property or to settle the financing or to refinance the property somewhere in the future before the end of the installments period of 120th, the redemption amount will also be easily calculated even by the customer himself/herself. Say the customer decides to sell the property after 2 years of the first installment of the property financing, the total installments that have been paid would be RM28,008 (= RM1,167 x 24 months). The redemption sum would be Selling Price minus total installments that have been paid and most probably plus any administration/processing fees. Therefore, the redemption sum will be RM112,342 (=RM140,000 – RM28,008 + RM350, assuming processing fee of RM350). If there is any expenses that has been charged on the financing during the period of 2 years such as late / follow-up charges etc., the extra expenses will be also added to the final redemption sum. The aforementioned recommended way to derive the redemption sum is more transparent and does not constitute any element of uncertainty or any other elements which are contrary to Syariah. It is fairer and the redemption sum will not be more than what is supposed to be paid by the customer.

As proposed in 2.2, the customer is renting a property from an Islamic financier until he/she fully settle the agreed rental payments. A new Mortgage/Tenancy Term Takaful could also be introduced to cover the rental payments on the customer should the customer pass away or has permanent disability. If these calamities happen on a customer, the remaining rental payments will be fully settled by the Takaful company and the property's legal ownership will be transferred to the customer (if he/she still alive) or to the customer's heirs based on Syariah regulations. All of these arrangements must be articulated clearly in the S&P, APA and ASA.

Conclusions

Pragmatically, all parties involved in Islamic Property Financing in Malaysia namely Syariah Advisory Board members, bank management and academicians must endeavor in concert so as to rectify the aforesaid loopholes and subsequently to execute the relevant practical recommendations. This paradigm shift is deemed paramount as Islamic Banking and Finance system in Malaysia has been established since 1983. There should be no excuse that the system is just formed and practiced whereby it would take much time to be perfected. All parties should realize that profit maximization as well as competition is not the ultimate aim in Islamic Property Financing. On the other hand, all must strive to ensure that all characteristics and practices in Islamic Property Financing in Malaysia adhere to Islamic Syariah. Furtherance, prominent Islamic scholars from assorted countries are opined that no profit could be made in an Islamic loan but we are allowed to gain profit in a trade. Therefore, the composition of Islamic Property Financing in Malaysia must be comprehensively a trade but not a loan that is much alike to conventional property loans which contains elements of *riba'* (interest) and *gharar* (uncertainty).

Reference

Al-Quran, Chapter 2:Al-Baqarah, Verse 275