



AN ANALYTICAL STUDY ON THE PRICING
OF ISLAMIC HOME FINANCING AND
CONVENTIONAL HOME LOAN IN MALAYSIA

BY

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ABSTRACT

A place called home is a basic need in human live. For most people, buying a house is a significant investment as house prices have been increasing steadily. Due to the high price, most Malaysians finance their house purchases with bank loan or financing. At the moment, Malaysians may opt for conventional home loan or Islamic financing for reasons suitable for them. For Islamic financing, the products available are BBA Home Financing or MM Home Financing. Statistical evidence shows that the amounts of conventional loans and Islamic financings for the purpose of house purchases have also been increasing every year. Despite stiff competitions by financial institutions in designing attractive home loans and financing packages to meet customers' demands, there are perceptions that Islamic home financing in Malaysia is more expensive than conventional home loan. However, claims have also been made that both conventional home loan and Islamic home financing products are competitive in terms of both product structure and pricing. This research paper attempts to analytically study the pricing of Islamic home financing versus conventional home loan to examine the competitiveness of the pricing of conventional home loan and Islamic home financing. Specifically, this research will identify the components of loan and financing prices, the formula used in calculating the various price components and the factors that affect the price calculations. This research will also gather available pricing related data and finally make comparisons of the various pricing components of conventional home loan and Islamic home financing. The finding of this research shows that the pricing formula for conventional loan and Islamic financing are the same. If all factors affecting pricing calculation are the same, the price of a conventional home loan and Islamic will be exactly the same. What makes a loan or a financing more expensive than the other is the product feature and other terms and conditions imposed by the loan or financing providers. There was some truth that product feature wise, Islamic BBA home financing appeared to be more expensive in the past. Now that Islamic banking products have evolved, the pricing of floating rates BBA and MM financing have become very competitive with conventional home loan products.

ملخص البحث

المنزل هو حاجة أساسية في الحياة البشرية. شراء منزل هو استثمار مهم لغالبية الناس بسبب الارتفاع المتصاعد لأسعار المنازل. القرض أو التمويل هو ما يمول به أكثر المالكين شراء منازلهم بسبب السعر المرتفع. حالياً، المالكين قد يختارون التمويل التقليدي للمنزل أو التمويل الإسلامي للمنزل لأسباب تناسبهم. بالنسبة للتمويل الإسلامي، البيع بضمن أجل أو المشاركة المتناقصة هما العقدان المتاحان لتمويل المنازل. الدليل الإحصائي يشير إلى أن كمية القروض الربوية و التمويلات الإسلامية بقصد شراء المنزل تزداد سنوياً. بالرغم من المنافسات الشديدة بين المؤسسات المالية في تصميم القروض المنزلية و أدوات تمويلية جاذبة لتلبية لطلبات الزبائن إلا أن هناك انطباع بأن التمويل الإسلامي للمنزل أعلى من القرض التقليدي للمنزل. في الجانب الآخر، مما قد قيل أن كلا من القرض التقليدي للمنزل و المنتجات التمويلية الإسلامية للمنزل متنافسة من ناحية تسعير وبنية المنتج. يحاول هذا البحث أن يدرس بشكل تحليلي تسعير تمويل المنزل بطريقة إسلامية في مقابل القرض التقليدي للمنزل لاختبار مدى التنافسية بين تسعير القرض التقليدي المنزلي و التمويل الإسلامي المنزلي. هذا البحث تحديداً سوف يحدد مكونات سعر القرض و التمويل و الصيغة المستخدمة في حساب هذه المكونات والعوامل التي تؤثر على حسابات السعر. هذا البحث أيضاً سوف يجمع البيانات المتوفرة المتعلقة بالتسعير و سوف يقوم بعد ذلك بمقارنات بين مكونات التسعير للقرض التقليدي المنزلي و التمويل الإسلامي المنزلي. نتيجة هذا البحث تشير إلى أن صيغة التسعير للقرض التقليدي و التمويل الإسلامي متشابهة. الذي يجعل القرض أو التمويل أعلى من الآخر هو خصائص المنتج و شروط أخرى يفرضها مقدمو القرض أو التمويل. قد كان شيئاً من الصواب سابقاً أن البيع بضمن أجل لتمويل المنزل إسلامياً يظهر بأنه أعلى لطبيعة هذا المنتج. الآن، منتجات المصرفية الإسلامية قد تطورت و تسعير الفائدة المتغيرة للبيع بضمن أجل و المشاركة المتناقصة أصبحت منافسة للمنتجات التقليدية للقرض المنزلي.

ABSTRAK

Sebuah tempat tinggal yang selesa adalah keperluan asas seseorang. Bagi kebanyakan orang, membeli sebuah rumah merupakan satu perbelanjaan yang amat besar memandangkan harga rumah semakin meningkat dari semasa ke semasa. Memandangkan harga rumah yang mahal, penduduk di Malaysia terpaksa mengambil pinjaman bank untuk membeli rumah. Penduduk di Malaysia mempunyai pilihan samada untuk mengambil pinjaman secara konvensional atau pembiayaan secara Islam berdasarkan factor-faktor yang bersesuaian bagi mereka. Bagi pembiayaan secara Islam, terdapat dua pilihan iaitu pembiayaan berasaskan BBA dan pembiayaan berasaskan MM. Data statistik menunjukkan jumlah keseluruhan pinjaman perumahan konvensional dan pembiayaan perumahan secara Islam meningkat setiap tahun. Walaupun terdapat persaingan hebat di kalangan institusi-institusi pemberi pinjaman dan pembiayaan Islam di dalam menyediakan produk-produk pinjaman dan pembiayaan yang dapat menarik pelanggan, ada pendapat mengatakan pembiayaan secara Islam adalah lebih mahal berbanding pinjaman konvensional. Namun ada pula hujah-hujah yang mengatakan pinjaman perumahan konvensional dan pembiayaan perumahan secara Islam adalah sangat kompetitif jika dibandingkan. Kertas penyelidikan ini akan membuat kajian analysis dalam perbandingan harga pinjaman perumahan konvensional dan pembiayaan perumahan secara Islam di Malaysia untuk melihat tahap daya saing kedua-dua produk ini. Secara lebih terperinci, kajian ini akan mengenal pasti komponen-komponen harga pinjaman konvensional dan pembiayaan Islam, formula yang diguna pakai didalam pengiraan harga pinjaman dan pembiayaan dan juga factor-faktor yang mempengaruhi pengiraan harga. Kajian ini akan juga cuba mendapatkan data-data yang bersesuaian dengan harga pinjaman and pembiayaan. Seterusnya, kajian ini akan pembuat perbandingan mengenai harga pinjaman konvensional dan pembiayaan secara Islam. Penemuan penyelidikan ini menunjukkan formula yang digunakan untuk pengiraan harga pinjaman and pembiayaan secara Islam adalah sama. Jika semua factor-faktor yang dapat mempengaruhi pengiraan harga di samakan, harga yang perlu dibayar untuk pinjaman konvensional dan pembiayaan secara Islam adalah sama. Yang menjadikan produk pinjaman atau pembiayaan itu lebih mahal atau murah adalah ciri-ciri dan polisi-polisi yang di tetapkan oleh pemberi pinjaman atau pembiayaan. Ia tidak ada kena mengena samada produk itu konvensional atau secara Islam. Ciri-ciri pembiayaan Islam di masa lepas adalah sedikit mahal berbanding pinjaman konvensional. Kebelakangan ini, produk pembiayaan Islam sudah semakin berkembang. Harga pembiayaan berasaskan BBA dengan kadar keuntungan terapung dan pembiayaan berasaskan MM sudah semakin kompetitif dengan pinjaman perumahan konvensional.

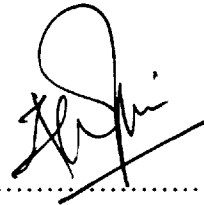
APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.



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This research paper was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance.



.....
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DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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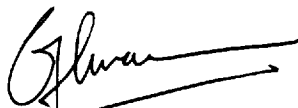
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LIST OF ABBREVIATIONS

AFR	Average Financing Rate
BBA	Al Bai Bithaman Ajil
BFR	Base Financing Rate
BIMB	Bank Islam Malaysia Berhad
BLR	Base Lending Rate
BNM	Bank Negara Malaysia
DP	Diminishing Partnership
EPF	Employees Provident Fund
FAQs	Frequently Asked Questions
GPP	Grace Period Profit
HLB	Hong Leong Bank
HLISB	Hong Leong Islamic Bank
IBS	Islamic Banking System
IFIs	Islamic Financial Institutions
IIMM	Islamic Interbank Money Market
IT	Information Technology
LIBOR	London Interbank Offer Rate
MM	Musharakah Mutanaqisah
MRTA	Mortgage Reducing Term Assurance
MRTT	Mortgage Reducing Term Takaful
MS	Microsoft Office
Q1	Quarter 1
RM	Ringgit Malaysia
SC	Shariah Council
TVM	Time Value of Money
YAB	Yang Amat Berhormat

CHAPTER ONE

INTRODUCTION

1.1 GENERAL BACKGROUND

There is a saying in Malay that “my home is my paradise”. In English, it is “home sweet home”. These are just some examples of “sayings” or “phrases” that indicate the importance of home for all of us. Indeed a place called home is one of the very basic needs of human life. A home provides a shelter to protect us from hot sunny and cold rainy days. A home also provides privileges for us to have our own privacies. For those of us who can afford to purchase our own dream homes, we are very lucky for the cost of buying a house is getting more and more expensive by the day. Houses which fall under properties category are one of the two sectors (the other is stock market) that absorb the most inflation.

According to Valuation and Property Services Department, Ministry of Finance Malaysia, national house price index rose 6.5% from Q1 2010 to Q1 2011 after annual increases of 7.9% from Q1 2009 to Q1 2010. In Kuala Lumpur, the house price surged by 11.4% from Q1 2010 to Q1 2011. The national average price of houses was RM 201,851 in Q1 2011.

Since owning a house requires huge sum of money which most people cannot afford to buy in cash, a definite alternative in this modern world is to resort to external financing. Before the introduction of Islamic financing, the only option was a conventional riba based loan. Today, there are of choices of either conventional loan or Islamic financing. Statistical evidence shows that the amount financed by financial institutions for the purposes of house purchases increases every year. Table 1.1 shows

the total amount of loans and financings given by Commercial Banks, Islamic Banks and Merchant or Investment Banks as at last quarters every year from 1st quarter 2001 to 3rd quarter 2011.

Table 1.1
Total Amount of Loans and Financing given by Commercial Banks, Islamic Banks and Merchant or Investment Banks

Year	Mar	Jun	Sep	Dec
2001	51,501.3	53,477.7	56,414.0	59,118.0
2002	60,789.9	63,325.3	67,203.4	69,207.1
2003	71,602.3	75,073.2	76,790.1	79,793.2
2004	82,879.2	87,253.8	92,177.8	96,398.4
2005	99,296.9	103,036.2	108,577.9	112,423.1
2006	113,947.1	118,841.9	122,687.2	138,235.9
2007	139,488.1	141,658.2	146,595.5	150,346.1
2008	159,263.4	164,668.2	171,178.0	177,063.1
2009	184,025.4	189,418.6	195,151.6	199,285.2
2010	206,436.9	213,274.0	220,875.0	227,790.4
2011	234,538.7	242,153.7	250,458.3	N/A

Note: Data was extracted from BNM Monthly Statistical Bulletin

In tandem with the overall growth of amount financed for house purchases, statistical evidence also shows that Islamic financing provided for purchases of residential property by Islamic Banks, Islamic Banking System (IBS) of Commercial Banks and IBS of Investment or Merchant Banks increases every year. Table 1.2 shows the total amount of financing as at the end of every quarter from 2007 to 3rd Quarter 2011 (data is only available from Dec 2006).

Table 1.2
Total amount of Islamic Financing given by Islamic Banks, IBS of Commercial Banks
and IBS of Investment or Merchant Banks

Year	Mar	Jun	Sept	Dec
2006	NA	NA	NA	17,110.6
2007	17,282.6	17,418.9	17,645.2	17,860.6
2008	18,122.4	18,379.4	18,857.6	19,442.9
2009	20,186.8	21,141.5	22,272.0	23,768.2
2010	25,271.1	26,942.7	28,492.5	30,035.0
2011	31,247.1	32,798.3	35,129.0	NA

Note: Data was extracted from BNM Monthly Statistical Bulletin

Table 1.1 and Table 1.2 above show that the amount of Islamic Financing for house or residential property purchases increase consistently with the total amount of conventional housing loan and Islamic Financing. This shows that some people opt for conventional loans and some people opt for Islamic financings.

There are a few factors in choosing a loan or financing such as marketing strategy of the loan or financing provider, conveniences in the application and approval processes and conveniences in making the repayment. Of course, for those who observe Islamic religion, conventional loan may be out of question. For others, they could choose either conventional or Islamic based on factors suitable for them. For those who are more sophisticated and more financially literate, they will go to the extent of comparing which loan or financing products that give better value for money. This group of people will make comparison between loan and financing products available in the market and the likelihood is that they will opt for cheaper loan or financing.

1.2 PROBLEM STATEMENT

The general perception of Islamic home financing in Malaysia is that it is more expensive than conventional home loan. Mohd Nazari Ismail (2009) wrote “What irks many of those opposed to Islamic banking is that in numerous cases, the contractual prices of these *halal* Islamic banking transactions are more expensive than conventional banking contracts.” Haron and Wan Azmi (2005) stated that “In most cases, we often hear complaints from customers that financing from Islamic banks is more expensive than loans given by conventional banks.”

While the adverse claims on Islamic financing as stated above are quite common, on the other side of the coins, claims also have been made that things have changed for the better. Islamic Finance Asia August/September 2009 in its “Feature” column raised the issue of “Paying the Price: Conventional versus Islamic”. Writer Anna Maria Samsudin tried to find out “whether Shariah or conventional banking products would provide more value for money”. Anna Maria wrote “Baljeet Kaur Grewal of KFH Research said the answer to whether Islamic products are cheaper than their conventional counter parts depends on various factors, such as the comprehensiveness of the existing regulatory framework.” The governor of Bank Negara Malaysia (BNM) in her keynote address at the State Street Islamic Finance Congress 2008, Boston USA entitled “Islamic Finance: A Global Growth Opportunity Amidst a Challenging Environment” mentioned that “Islamic products have expanded into broader spectrum. . . . These products are competitive both in terms of product structure and pricing.”

It is evident that whether Islamic or conventional banking products are cheaper is a never ending debate. The perception of Islamic home financing being more expensive could be true at the early stage of Islamic banking era more than 20 years

ago when Selling Price of BBA Islamic home financing was calculated based on a fixed single rate. Since financing is based on fixed rate and Deposit is based on “floating” rate (rate of return is declared monthly) , as risk mitigations, banks offering BBA Islamic home financing used higher than conventional prevailing rate in calculating the selling price to be contracted with customer. Later on, floating rate BBA was introduced. While the Selling Price is still capped at higher than conventional prevailing rate, the actual effective rates that customers pay to banks are based on the prevailing rate. The different amount between total profit margin contracted in Selling Price and the actual profit charged to customers are given as rebate.

In determining the actual pricing of BBA home financing, there are many other factors to be considered. Whether it is more expensive or not, we need to calculate the effective rate. Effective rates will depend on the cash-flows patterns. The cash flows are affected by other terms and conditions as well as the product features. Recently banks have started introducing Islamic home financing based on Musharakah Mutanaqisah (MM) concept. The pricing model of MM home financing is different from BBA home financing. Now that Islamic financing products have evolved with new generation of Islamic home financing products (floating rate BBA and MM), is the perception of Islamic home financing more expensive than conventional home loan still valid?

This research paper attempts to analytically study the pricing of Islamic home financing versus conventional home loan to examine the competitiveness of the pricing of conventional home loan and Islamic home financing. Based on the findings of the various aspects of pricing mechanism and price components, conclusion will be

made on the pricing competitiveness of Islamic home financing and conventional home loans.

1.3 OBJECTIVE OF THE STUDY

1.3.1 Main Objective

The main objective of this paper is to analytically study the pricing of Islamic home financing and conventional home loan in Malaysia. The purpose is to determine whether the pricing of Islamic home financing products in Malaysia is as competitive as the conventional home loan products. The focus will be on the pricing of term home loan or home financing packages which cover the following home loan and financing products:

- i. Conventional Home Term Loan
- ii. Islamic BBA Home Financing
- iii. Islamic MM Home Financing

1.3.2 Sub Objectives

The sub-objectives of this research are as follows:

- i. To identify the components of financing and loan total prices
- ii. To identify the formula used in calculating the various price components
- iii. To identify what other factors that affect the calculation of the various price components
- iv. To gather available conventional home loan and Islamic home financing pricing related data
- v. To make comparisons of the various pricing components of conventional home loan and Islamic home financing

1.4 CONTRIBUTION TO RESEARCH COMMUNITY

While the main objective of this research is to analytically study the pricing of Islamic home financing and conventional home loan, the sub objectives will identify and work out detail calculation of both Islamic home financing and conventional home loan. In addition, other factors affecting the pricing calculation will be identified. These will provide additional reference materials for others whom are interested in this area.

CHAPTER TWO

LITERATURE REVIEW

2.1 LITERATURE REVIEW

The residential sector has been playing a significant role in the Malaysian economy, thereby contributing towards the development of home financing. This can be evidenced by the competition running amongst the commercial banks, which are continuously designing attractive housing financial packages to meet the increasing demand for houses. The following figures that had been sourced out from Bank Negara Malaysia (BNM), which had stated that the total “outstanding loans of residential property in commercial banks increased by 10.3 per cent from RM 174 billion as at 31 December 2007 to RM 192 billion as at end 31 December 2008” further support the occurrence above. The figures above represent 26.5 per cent of total financing (BNM, 2008), and based on these financial performance indicators, it has landed itself as the highest sector.

Prior to the setting up of Bank Islam Malaysia Berhad (BIMB) in 1983, Malaysian Muslims had conventional home loan as the only option, which is based on interest. Therefore, the establishment of BIMB had led to the development and growth of Islamic banking products, where Bai Bithaman Ajil (BBA), which is a deferred instalment sale, was introduced as the first concept for Islamic home financing. It is by far the most predominant and widely used concept in Islamic home financing by the financial institutions in Malaysia. BBA is based on deferred instalment sale whereby the bank will purchase the house from the customer first and sell it back to the customer later, inclusive of a profit margin. This profit margin is

capitalized upfront in the selling price, which remains fixed until the end of the financing tenure (Abdul Razak and Md. Taib, 2011).

In an effort to continuously generate an innovative environment in the nascent Islamic banking and finance industry, a new instrument – floating-rate BBA had been introduced, as an alternative to the predominant mode of fixed-rate BBA that had been frequently used in financing portfolios. The floating-rate BBA was structured to enable the Islamic financial institutions (IFIs), which operate in a dual banking environment to constantly match the current market financing rate in order to provide matching returns to their depositors, thereby avoiding any mismatch risk. The introduction of this new instrument was mainly to counter the funding mismatch that the IFIs are experiencing because their long-term financing was funded by short-term bank deposits which can give variable returns.

The floating-rate BBA was designed to allow the IFIs to vary the profit rate for the financing rate, in order to increase the deposit rates, so that the mismatch risk can be mitigated and the depositors will gain satisfactory return rates when compared against the conventional market. This will also ensure that the depositors will not switch to conventional banking which otherwise could adversely affect the Islamic banking operation. This will inadvertently reduce the vulnerability of the IFIs to exposure in market risk especially in a banking environment where Islamic banking and conventional banking operate in parallel (Bank Negara Malaysia website, n.d).

This BBA financing concept however had been deemed as not being *Shariah* compliant and not acceptable especially by international scholars (Rosly, 2005), due to its similarities to conventional debt financing, because the bank does not take the risk of ownership and liability of the property, and besides that, there is an implicit dependence on using interest rate as a benchmark in determining the bank's profit