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## Analysis of the Development of Islamic Home Financing History in Malaysia

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### Abstract

*Home is a need since ancient times hitherto. Nowadays, to acquire a home requires high capital until one needs to get funding from other party either from individual or institutional. As a result, financial institutions were established and involved in assisting buyers. In the context of Malaysia, the facility led to an establishment of a housing financing contract between bank and buyers since before the Independence Day. For Muslims, the contract was formulated to be Shariah compliance within conventional framework. Hence, this study aims to examine the development of Islamic housing financing contracts since before the independence hitherto. This study using a qualitative method in which the researchers have applied a library research method to obtain secondary data through books, journals and official websites. The study found that housing financing contracts have undergone a phase of change from a simple to a complex contract form by combining multiple contracts. The study also found that the financing contracts have undergone a transformation phase of Islamic-based products that are based on sale and purchase to Islamic based partnership products which were more in line with Shariah requirements. Housing financing products are also change to a better direction as Islamic banks as well as Shariah advisors always responded to any critics to improve their products.*

**Keywords:** Islamic Housing Financing, Bank Islam, History, Malaysia, Shariah compliance

### Introduction

Home is a basic necessity for every human being since ancient times until now (Azli et al., 2011). But to get a home is challenging at the present time as the value is increasing and hence require high expenses. Its high value cannot be saved for a short period of time, and this requires other financial resources. Currently, people get such resources through various means either through financing, borrowing, saving money gradually or even renting (Besar et al., 2012).

However, for Muslims, they are forbidden to involve in as the Quran has commanded Muslims to do sales and avoid usury (Q2:275). While at the same time, it is hard for individuals to lend a large amounts of money without taking any interest or benefit. Therefore, the Islam prohibited loan and instruct Muslims to involve in other muamalat methods in getting funds for buying home. It is found

that since before Malaysia's independence, Muslims have gotten an enormous fund for financing. The product of Islamic housing financing was also boomed when it was initially offered by the Islamic Bank since the launch of the Islamic Banking Act 1983 which came into force on 7 April 1983 (Ismail et al., 2015). From the perspective of the study gap, there has been no study to discuss the details of the historical development of Islamic housing financing in Malaysia. Hence, this study is to investigate the historical development of Islamic housing financing in Malaysia since before the establishment of Islamic Bank in Malaysia as an alternative to conventional-based banks.

### **Historical Development of Islamic Housing Financing in Malaysia**

#### *Before Independence 1957*

Based on history, Islamic financial transactions have been practiced in Malaya as early as 16th century through the influence of Malacca's law. It was witnessed that most of the states in Malaya at that time have similar provisions with Legal Code of Malacca on muamalat matters (Cortesa, 1944; Fang, 1976; Winsted, 1958; Shellebear, 1977). In the Code, muamalat affairs are listed from clause 29 to clause 34.2 among which the section 30 that have underlined the prohibition of riba (usury) in any transaction (Nasohah, 2004). However, the listed dealings were handled in informal manners such as between sellers and buyers.

Among traditional practice was "conditional sale" that were applied among Muslim communities, especially by farmers in Kedah, Perlis, North Perak and Kelantan pre-colonial times. This contract was practiced in replacing money lending scheme that became the core economic business of the Chettiers in Malaya (Maxwell, 1974; Gullick 1987; The National Land Code, Section 4 (2)). Instead of colonial system that based on usury, the chettiers also play a significant role in lending and loaning services that based on interest charge.

According to Buang (1993), the conditional sale is a resemblance of Islamic principle which was known by al-bay' al-wafa, that is the sale with the option to repurchase. Al-Bay' al-Wafa' contains two words that are al-bay' means sale, and al-wafa' means repayment or settlement of the debt. In application, Islamic jurists have defined it as a sale and purchase by two parties that involve a condition that the goods sold can be repurchased by the seller upon a specified period of time (al-Zarqa', 1968). The purpose of the transaction is to obtain a sum of capital that are free of usury and the buyer have rights to benefit of land or other asset, during the period of agreement (Hasan, 2005). If the seller is failing to repurchase the asset during the time agreed, the property is belonging to the buyer for permanent (Buang, 1988).

Originally, the contract was found being practiced by people in Central Asia (Bukhara and Balkh) in the middle of the 5th century of Hijra to avoid loaning activities and usury. The practice continued to expand into the Middle East, then brought to the Malay Archipelago by Muslim traders which is in line with the inclusion of Islam (al-Sabuni, 1980). The practice is not just to obtain a capital but also prevent usury elements. Then it develops to be a local culture among Malay Muslim community who aware in avoiding usury. Usually, this contract is practiced in the sale of land or other fixed properties with provision to repurchase within a specified period. During that period, the buyer can benefit and occupy the land completely (Buang, 1988).

Such practice is as an alternative to avoid involvement in usury and the fact was mentioned by colonial judges as well as by Malay judges. In the case of *Tungku Zahara v Che Yusof* (1951), Briggs J.

decided that the purpose of the conditional sale transaction was to obtain credit (debt) and to give the mortgagor (land buyer) a corresponding indemnity without engaging in the practice of *riba* (usury). In the case of *Ibrahim* (1968), Azmi as the Chief Judge of Malaya had made the same statement that the customary practice of the Kedah farmers was basically a conditional sale, in which the seller had the right to repurchase his property and to enable the buyer (borrower of money) to benefit from legal transactions according to Islamic law (Yasin, 1996). These statements have proven and reinforced that *bay' al-wafa'* was an alternative arrangement by the Malay community at that time to avoid *riba* transactions.

However, the form of dealing became culture of local community and they used to take the arrangement in getting instant capital. The focus group of this mode of dealing was revolving around folk farmers who living in kampong and rural community (Shamsuddin, 1988). The richer among them would be the focal point of the villagers to sell their asset. As sum, the type of dealing is significant to be developed as a basis of shariah compliance products, especially in initiating a non-usury funding. From other perspectives, it is a kind of mortgage where value and benefit of the asset will become as financial considerations. In addition to the land for agricultural activities and income sources, the land was also the place to live. The Scheme was continued until after the independence even though after the establishment of Bank Islam in Malaysia on 7 April 1983 (Maxwell, 1974; hooker, 1974; Gullick, 1987). Indirectly, the practice became principle of home financing at that time under the contract of conditional sale (*al-bay' al-wafa'*). However, majority of Islamic jurists have denied the validity of *al-bay' al-wafa'* and consider it as an irregularity sale because there is an element of *hilah* and involve with obligatory terms in the sale and purchase (Hawwa, 2007). The similar resolution also found by the *Majma' Fiqh al-Islami* in 1992 (*Majma' Fiqh al-Islami*).

#### *After Independence 1957*

After Malaysia gained independence, the legacy of colonial influence continuing especially in financing matters which practice interest or usury in lending contract. The practice is contrary to the Islamic law which resulted difficulty for Muslims to get capital financing from financial institutions. Only in 1969 after the establishment of Lembaga Urusan Tabung Haji (LUTH), Muslims in Malaysia were provided with Shariah compliance institution (Aziz, 1959; LUTH, 1980). However, the institution is only provide saving facility to enable Muslims to save money for pilgrimage (LUTH, 1991). The need for Islamic banks to be established in Malaysia become obvious when looking at the success factors of the establishment of Islamic banks in some Muslim countries such as Qatar, UAE, Egypt, Pakistan and Iran.

Therefore, on 1 March 1983, the first Islamic bank was established in Malaysia known by Bank Islam Malaysia Berhad (BIMB). It was incorporated as a company under the Companies Act 1965. The objective of the establishment is to offer Islamic banking scheme that is fully Shariah compliant. Among of the Islamic products that were introduced was the Islamic housing financing product. In early establishment of Islamic bank in Malaysia, it took the model of overseas Islamic bank namely Faisal Islamic Bank in Sudan and Faisal Islamic Bank in Egypt (Hassan, 2005). The establishment of BIMB as well as its instruments for the first decade was contributing as the first phase of implementation of the Islamic Banking System (SPI) in Malaysia (Ismail, 1983).

The second phase start after 1990s, that brought SPI system from the periphery of the banking to the mainstream structure (Yakcob, 1996). At this stage, several phases were initiated which allowing conventional financial institutions to offer Islamic banking services. All commercial banks, merchant banks and finance companies were eligible to participate in SPI. The first phase was launched in March 1993 involving the three largest commercial banks in Malaysia namely Malayan Banking Berhad (MBB), Bank Bumiputera Malaysia Berhad (BBMB) and United Malayan Banking Corporation Berhad (UMBCB) (Borhan, 2001). The three banking institutions had granted permission to offer SPI, beside their current role in conventional banking. Among facilities that were offered specifically depository accounts, asset ownership financings such as residential and trade financing. All products were based on Shariah principles that are *wadi'ah*, *mudarabah*, *bay' bithaman' ajil*, *ijarah*, *kafalah* and *wakalah* (Ghani, 1999). The SPI service had received encouraging response from the public. Through 281 branches of the three banks, within two months of operation, they had attracted 4,146 depositors and raised a total of 30 million deposit money (Guan, 2002).

The second phase of the implementation of SPI was launched on 21 August 1993 which involves 10 other financial and banking institutions. Among them were Perwira Habib Bank Berhad, Arab Malaysian Finance Berhad and Maybank Finance Berhad. At that time, the entire branch of those financial institutions were offering SPI that amounted to 440 units, excluding 44 of the BIMB branches. Until end of December 1995, the number of financial institutions that participated in SPI was 42, with a total of branches offering SPI facilities was 1472, involving 66 BIMB branches and 1406 of other banks' branches (Borhan, 1999).

On 1<sup>st</sup> October 1999, Bank Muamalat Malaysia Berhad (BMMB) was established as the second Islamic bank in Malaysia. BMMB is developed by the government's efforts to strengthen the Islamic banking sector to meet the growing demand for the public on Islamic banking services (Borhan, 2011). On May 5, 1993, the Shariah Banking System was introduced by Bank Kerjasama Rakyat Malaysia (Bank Rakyat) which started through its four branches. By the end of 1995, 40 Bank Rakyat branches were fully operating as Islamic banking institution (Bank Rakyat, 1994).

From the perspective of home financing, as BIMB took Faisal Islamic Bank's banking model at the beginning of its establishment, it come together with their financing products such as *bay' 'inah* and BBA to be practiced in Malaysia. The two products also recognized by other Islamic banks during the early phase of the establishment of Islamic banks in Malaysia (Shahwan, et al., 2013). In sum, these products also were offered by other banks that operate on dual-window scheme. According to Hanafi (2012), *bay' 'inah* and BBA products had dominated for 35 years since the commencement of Islamic banking in Malaysia. Meanwhile, Islamic banking products at international level more popular with *murabahah*-based products which using direct selling on profit purposes. However, in Malaysia the practice of Islamic financing within conventional system have led bankers tend to count profit at par with conventional product. Hence, to avoid incurring more liability on home financing and get profit as similar as the other products, *bay' inah* was preferred. In addition, the need for buyer to pay at least 10% to developers has raised constraint to apply *murabahah* scheme. Generally, Islamic housing financing products in Malaysia have three phases, namely the stage of emerging debt-based products such as BBA and *tawarruq*. The second stage was hire-purchase products such as *al-ijarah muntahiyyah bi al-tamlik* and *al-ijarah mausufah fi al-dhimmah* while the third stage was producing equity-based products such as *musyarakah mutanaqisah* (Hanafi, 2012).



In detail, BBA or *bay' bithaman ajil* is a combination of three contracts, i.e. *al-bay'* (sale), *thaman* (price) and *ajil* (delay of time). In terminology, BBA is a sale and purchase agreement between the owner of goods and the buyer where the owner of goods handed the items to the buyer immediately, and the buyer delayed the price of payment until a certain period that was agreed between them (Aziz, 2013). Under BBA contract, element of *bay' inah* embedded in the contract (Shahwan, et al., 2013). Meanwhile in real process, financing bank does not has a connection with developer to purchase a home, as it is between buyer and bank only. When buyer paid 10% payment to developer, the former has to get financing from bank and therefore involve *bay' inah* contract with bank (shuib, et al., 2013). Until year 2000, BBA products dominated over other products in Malaysia as they were popular and widely used (Hassan, 2005).

Based on the practice of *bay' inah* through BBA in Malaysia, it has been widely criticized among Middle Eastern scholars as the contract is overwhelmed with issues of trickery and usury which were prohibited by Shari'ah (Zain, et al., 2017). Hence, some of the Islamic banks such as BIMB, Bank Rakyat and Arab (M) Bank were shifted to *tawarruq*-based product which was approved by the Shariah Advisory Council of the Central Bank in its 51st meeting on 28 July 2005. The acceptance of Islamic Financial Institutions (IFI) towards *tawarruq* product was encouraging and favored among other products (Ab Rahman, et al., 2010). The modus operandi of *tawarruq* is slightly difference compared to *bay' inah* as the former is involving two levels of transactions. At the first level, transaction involves a credit purchase between buyer and seller of an asset, and at the second level, the buyer will then sell the asset in cash to the third buyer. Majma 'al-Fiqh al-Islami defines *bay' al-tawarruq* as to buy something in possession of a seller on a debt, then a buyer sells it to a third party for obtaining cash (Ab Rahman, et al., 2010).

This contract is called *bay' al-tawarruq* because when a buyer buys an asset on credit, the buyer does not intend to use or utilize it, but only wants to sell it again for cash. *Tawarruq* contract is also known as commodity contract of *murabahah* and is widely used in depository product, financing, asset management and liabilities, and risk management. The *tawarruq* contract contains several agreements namely credit purchase agreements and resale asset for cash. Based on current practice on *tawarruq* scheme such as in the Muamalat bank, the financing structure involves several other contracts namely *bay' murabahah*, *wa'd mulzim*, *wakalah* and *bay' wadi'ah* (Mahyudin, 2015).

In the third phase, banks began offering rental and purchase-based product that was also included in debt-based financing categories to diversify financing products. It was known as *al-ijarah muntahiyyah bi al-tamlik* and *al-ijarah al-mausufah fi al-dhimmah*. Generally, *ijarah muntahiyyah bi al-tamlik* is referred to *ijarah* contract that was a beneficial ownership which acquired through exchange of payments whether in the form of equivalent assets, debt or benefits (Suhaimi, 2010). Practically, *ijarah* agreement only involves benefit taking of an asset from owner (bank) to tenant (customer), without involving a transfer of property rights. The owner still owns the ownership rights those assets (Bank Negara Malaysia, 2009).

*Ijarah* contract in its original form is not a means of financing, as it is a lease contract. However, it has been invented as a financing instrument by solemnizing the contract of leasing with full ownership transfer. Hence, instead of taking benefit on the asset, the tenant also owns an ownership at the end of the contract. This innovation creates a product named *ijarah muntahiyyah bi al-tamlik* which comprises three contracts, i.e. rent, sale and *wa'd mulzim* (Hakimah, et al., 2016). The lease deal will

take effect at the initial stage of the contract whereby the tenant will rent and pay the fee to an owner (bank) according to agreeable rate and identified timeframe. After rental period is accomplished or all payments have been made, the rental asset become a tenant's purchased property (Kuwait Finance House, 2018). According to Ayub (2007), *ijarah muntahiyyah bi al-tamlik* contract is a hybrid contract with good prospects as there is no controversial issues found in the arrangement of contracts.

In a meantime, contract *ijarah mausufah fi al-dhimmah* is almost similar to contract *ijarah muntahiyyah bi al-tamlik*, both of them are using *ijarah* contract. *Ijarah al-dhimmah* can be defined as a sale of future benefit to obtain cash or a *salam* contract to obtain benefits whether the benefit arise from the assets or services. It was acknowledged as *ijarah al-dhimmah* because benefit of the asset was placed on the tenant's liability which not attribute to the asset itself. It can also be termed as *ijarah* whose benefits are guaranteed as the lessor assured to provide such benefits in any event. This contract is also considered a *salam* where the subject is a benefit. *Ijarah al-mausufah fi al-dhimmah* contract has involved four sub-contracts namely *istisna'*, *ijarah*, *bay'* and *wa'd mulzim*. The modus operandi of financing involve bank as the homeowner financing that funding a developer to build house. This process indirectly uses an *istisna'* contract. Subsequently, the bank leases the house to customer based on the amount and rental period agreed upon using the lease contract. Then at the end of the rental period, the bank will sell the house to the customer either at the rent price or nominal value, using the sale and *wa'ad* contracts.

Although the *al-ijarah muntahiyyah bi al-tamlik* product was approved by the Shariah Advisory Council (SAC) of Malaysian Central Bank on 1997 and 2003, followed by *ijarah mausufah fi dhimmah* in 2010 as a housing financing product, but until to this day, both products are not widely applied in Islamic home financing products (Bank Negara Malaysia, 2010).

In the fourth phase, banks began to offer equity-based products such as *musharakah mutanaqisah* (MM) or diminishing partnership. This product was developed by muamalat scholars and subsequently was implemented by Islamic banks to highlight the concept of profit and loss sharing between the bank and the client, which is very different from conventional concepts that only prioritize profit in whatever risk and condition. This product was approved by the Shariah Advisory Council (SAC) of Malaysian Central Bank at the 56th meeting held on 6 Feb 2006 (Osmani, et al., 2010). MM product has started offering by Kuwait Finance House (Malaysia) Berhad (KFH) (2019) on February 17, 2006, Citibank (2019) on March 6, 2007, Maybank Islamic (2019) on September 12, 2007, RHBIB (2019) on November 22, 2007, Affin Bank (2019) on May 6, 2011, and followed by HSBC, SCS and PIB (Osmani, et al., 2010). Internationally, *musharakah mutanaqisah* product has been approved at the international seminar on Islamic banks in Dubai in 1979 where at that time, only few of the Islamic banks using the product (Smolo, et al., 2011). *Musharakah mutanaqisah* contract is a concept of a downward partnership that ends the contract with ownership. *Musharakah* from the Arabic term is derived from the basic word that is *sharika* or *sharikah* which means to associate or share. *Mutanaqisah* means it is diminishing. According to the term, *musharakah mutanaqisah* is a form of partnership in which one of the partners' promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him (Samsudin, 2015). *Musharakah mutanaqisah* contract involves several other contracts that merge in an agreement which consist of *musyarakah*, *ijarah* and *bay'*. In the implementation of this contract at RHBIB, there

was one more contract be added namely *wa'd mulzim* (Shuib, et al. 2011). According to Shuib (2011), the combination of those contracts is in line with the Shariah after fulfilling requirements of every contract.

Table 1: Islamic Housing Financing Products (Bank Negara Malaysia, 2019);

	Bank Names	<u>Housing Financing Products</u>
1	Kuwait Finance House	<i>Ijārah Muntahiah Bi Tamlik</i>
		<i>Ijārah Mauṣūfah Fi Dhimmah</i>
2	Bank Islam	<i>Tawarruq</i>
3	Maybank	<i>Tawarruq</i>
4	Am Bank	<i>Tawarruq</i>
5	Public Bank	<i>Bai Bithaman 'Ājil</i> <i>Mushārah Mutanāqishah</i> <i>Ijārah Mawṣūfah fī al-Dhimmah</i>
6	Alliance bank	<i>Bai Bithaman 'Ājil</i>
7	Bank Rakyat	<i>Tawarruq</i>
8	Affin Bank	<i>Mushārah Mutanāqishah</i> <i>Tawarruq</i>
9	BSN	<i>Tawarruq</i>
10	Hong Leong Islamic Bank	<i>Tawarruq</i>
11	RHB	<i>Mushārah Mutanāqishah</i>
12	Al-Rajhi	<i>Tawarruq</i>
13	Bank Muamalat	<i>Tawarruq</i>
14	CIMB Bank	<i>Tawarruq</i>
15	OCBC Bank	<i>Ijārah Muntahiah bi Al-Tamlik</i>
16	MBSB Bank	<i>Tawarruq</i>

Based on table 1, there are now 16 banks that offer Islamic housing financing services based on different products, i.e. *ijarah muntahiyah bi tamlik*, *ijarah mausufah fi dhimmah*, *tawarruq*, *bay' bithaman 'ajil* and *musharakah mutanaqisah*. The majority of the financing products offered are based on *tawarruq* where 11 banks offer it. It was followed by *musharakah mutanaqisah* based products where three banks offer it. Then, followed by *ijarah muntahiyah bi tamlik*, *ijarah mausufah fi dhimmah* and *bay' bithaman 'ajil* which each of them are offered by two banks.

## Conclusion

Based on an above discussion, the source and types of Islamic funding before independence were offered and managed by individuals. However, after independence, the development of Islamic



financing activities gradually changed from individual to institution, especially after the establishment of the Islamic bank in Malaysia. The progress was continuing to apply when the Central Bank had launched an Islamic banking scheme where conventional banks also were allowed to offer them. The consequence has resulted all registered banks which involved in offering Islamic financing products can offer the facilities. Hence, this has contributed to the greater supply of Islamic housing financing to accommodate Muslims in Malaysia.

Islamic housing financings have undergone a transformation phase from a simple product to a complex form. This can be seen through *bay' al-wafa'* before independence, then expanded to the BBA product that based on a *bay' al-'inah* after independence. Then the product continues to expand in the form of *tawarruq munazzam* contract. Subsequently, it shifted to rental-based products, i.e. *ijarah muntahiyyah bi al-tamlik* and *ijarah mawsufah fi al-dhimmah*. Then, the changes remain to a partnership based under the brand of *musharakah mutanaqisah*. Overall, the transition took place on several factors, among which as a respond to criticisms from muamalat scholars either locally or internationally. The rest are wanting to diversify Islamic housing financing products, utilizing the Islamic muamalat contracts in classical fiqh as well as absorbing the elements of sharing in the face of economic risks. As sum, the development of Islamic housing financing products is improving and offered in several products which compliance with Shariah.

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