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Sub-prime Issue : How Islamic Financing Able To Solve The Problem During Financial Crisis

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Abstract

Sub-prime crisis rise due to imprudent credit practice by the lender beside the other factors. Unethical element consist in the conventional financial system such as permissible speculation and allowable selling of debt's mortgages via asset securitization created the situation become worse. In Islam, Islamic financing have their own way to fiancé the mortgages which is permissible in Islamic Principles. Islamic Principles prohibits the payment and collection of interest and highly complex instrument such as derivatives and other "creative" accounting practice are banned. Transaction must be backed by real asset that avoiding repackaged sub-prime mortgages. The credit rating under Islamic banking and finance evaluates real term business potential and growth trends, instead of evaluating manipulation asset value which causing damages to the credit and economy.

JEL classifications: F00, G00, H00, H89
Keywords: Sub-prime Issue, debt mortgages, economic impact, Islamic Principles, Islamic Financial solution.

Contents

1.0 INTRODUCTION

Sub-prime refers to the borrower that is not ‘prime’. These are borrowers who might be less likely to repay a loan. Sub-prime borrowers may be classified as sub-prime because of:

- Bad credit or lack of history
- Low income or poor debt to income ratio
- Large loan relative to the securing property

The mortgage crisis happened in US in 2007 was a result of too much borrowing and flawed financial modeling, largely based on the assumption that home prices only go up. Greedy also played an important part as some of the house being used as an investment purpose.

Before year 2000, owning a home is part of ‘American Dream’, and during that time, homes are expensive and most people need to borrow money in buying and own their dream house. In the early 2000’s, mortgage interest rate were low, which these had allowed people to borrow more and more money at a lower monthly repayment. In addition, home price has increased dramatically.

As the value of the house increased, homes owner then refinance and took second mortgage to get cash out of their home’s equity. Lenders willing to participate and give out the financing as they assume the homes are good collateral. Some of this money then was spent wisely. Americans spent almost USD800 billion per year more than they actually earned. Household debt has grown from USD680 billion in 1974 to USD14 trillion in 2008, with the total doubling since 2001. During 2008, the average U.S household owned 13 credit cards.[1]

[1] Zakaria: A more Disciplined America/newsweek business/ newswee.com (http:newsweek.com/id/163449)”

2.0 THE CRISIS BEGIN

As practicing in economic capitalist, the financing is based on lending of interest and the interest is always up and down depending on a various factors such as economic condition and government policy.

The cycle also happened in U.S. Interest rate began to rise and housing price started to drop moderately in 2006 – 2007 in most of the part in U.S. Refinancing also become more difficult. Default and foreclosure property cases increased obviously. Home prices not go up as expected and Adjustable Rate Mortgages (ARM) interest rate was reset higher.

The value of U.S sub-prime[2] mortgage was estimated at USD1.3 trillion as of March 2007. In the third quarter of 2007, sub-prime ARM making up 6.8% of U.S mortgage outstanding also accounted for 43% of foreclosure begun during that quarter [3]. By October 2007, about 16% of sub-prime ARM was either 90% days delinquent or the lender had begun foreclosure proceeding, triple the rate of 2005. By January 2008, the delinquency rate had risen to 21% and May 2008 it was 25% [4].

The value of all outstanding residential mortgages, owned by U.S households to purchase residences housing at most families was USD9.9 trillion as of year end 2006, and USD10.6 trillion of midyear 2008. During 2007, lenders had begun proceeds foreclosure on nearly 1.3 million properties, a 79% increase over 2006. As of August 2008, 9.2% of all mortgages outstanding were either delinquent or in foreclosure. About 1 million U.S residences completed foreclosure between August 20007 and October 2008[5].

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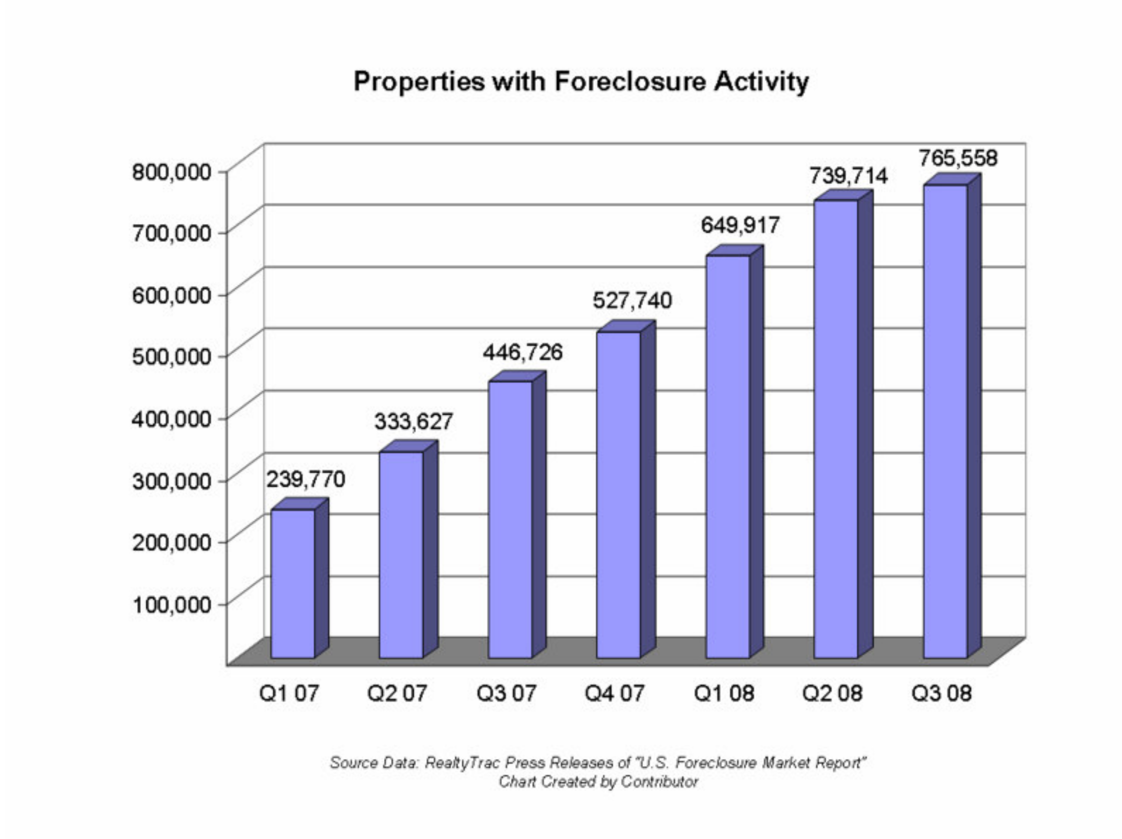
2 How to serve is subprime press? (http://www.msnbc.msn.com/id/17584725)".

3 Mortgage bankers association (2007-06-12) " Delinquencies and foreclosure interest in latest MBA National Delinquency Survey (http://www.mbaa.org/newsandmedia/presscenter/58758.htm)

4 Bernake, Ben S. "Mortgage Delinquency and Foreclosure" (http://www.federalreseve.gov/newsevents/speec/bernanke20080505a.htm) Washington, D.C

5 CNN Foreclosure (http://money.cnn.com/2008/11/13/real_estate.foreclosure_october/index.htm?Postversion=2008111303)

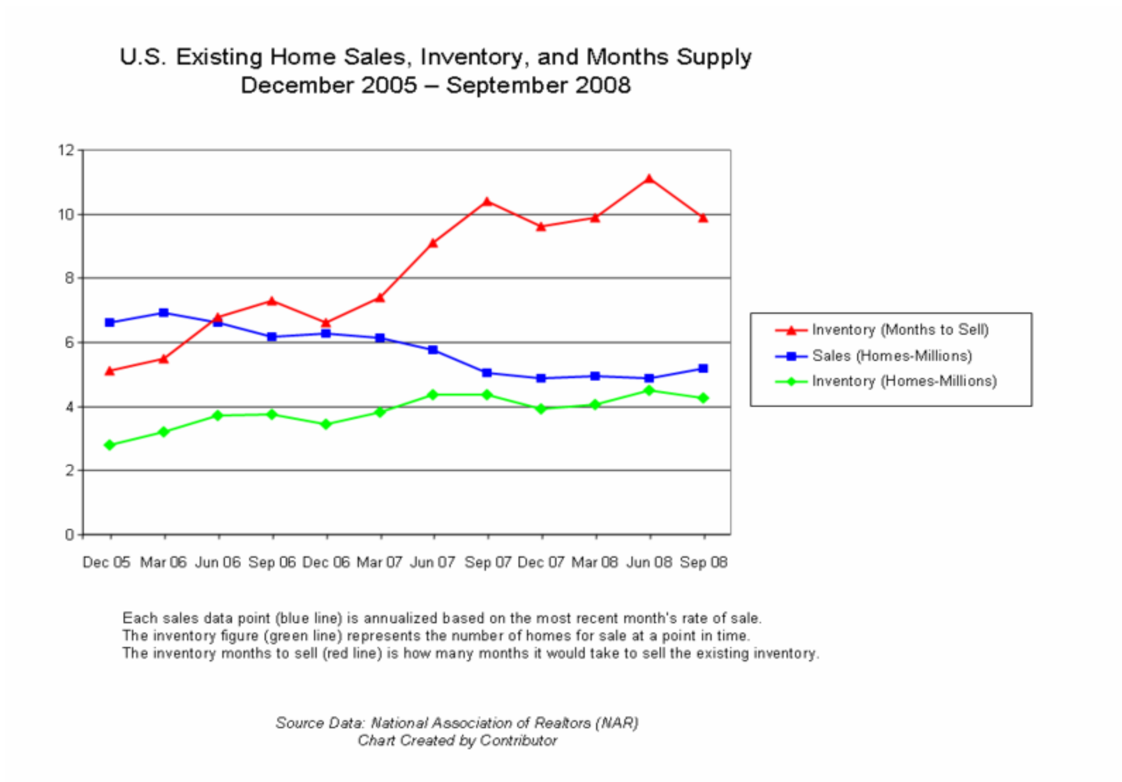


By September 2008, U.S housing value had declined by over 20% from mid-2006 peak. Unexpected decline in house prices and value means, many borrowers have zero or negative equity in their homes – meaning their homes were worth less than their mortgages/loans. As at March 2008, about 8.8 million borrowers – 10.8% of all homeowners [3] had negative equity in their homes, a number that is expected to increase to 13 million in Jan 2009. Declining in mortgage payment also reduces the value of mortgage-backed securities, which erode the net worth and financial health of banks. This complicated cycle is contributed to the crisis [6].

Increasing foreclosure cases contribute to the increasing the number of houses for auction. The number of new homes sold in 2007 was 26.4% less than in the preceding year. By January 2008, the stock of unsold new house 9.8 times the December 2007 sales

[3] Mortgage bankers association (2007-06-12) " Delinquencies and foreclosure interest in latest MBA National Delinquency Survey (http://www.mbaa.org/newsandmedia/presscenter/58758.htm)
[6] NYT- How to help people who's homes are underwater (http://online.wsj.com/article/sb/22697004441035727.html)

volume, the highest value of this ratio since 1981. Overhang of unsold homes will lower further house prices (currently almost 2.9 million were vacant). As the price declining, more homeowners were at risk of default or foreclosure. House price are expected to continue declining until this stock of unsold homes or the excess supply declines to normal levels.



3.0 CAUSES

The reason for sub-prime crisis are varied and considered complex. In it "Declaration of the summit on Financial Market and the World Economy", dated 15 Nov 2008, leader of the group of 20 cited the following causes;

"During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yield without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practice, and consequent excessive leverage combined to create vulnerabilities in the system, policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory action”[7].

3.1 Financial Innovation

Over the past 60 years, a various financial innovations have gradually made it possible for lender to sell the right to receive the payments on the mortgages they issue, through a process called securitization. The resulting securities are called mortgage back securities (MBS) and collateralized debt obligation (CDO). Most American mortgages are now hold by mortgage pools, the generic term for MBS and CDO of the USD10.6 trillion of U.S residential mortgages outstanding as of midyear 2008, USD 6.6 trillion were held by mortgage pools, and USD3.4 trillion by traditional depository institutions.

3.2 Speculation

Speculation in residential real estate and home investments also one of the major factor contributing to sub-prime. During 2006, 22%(1.65 million units) of homes purchased were for investment purpose, which and additional 14% (1.07 million units) purchased as vacation homes – means, about 40% of homes purchases were not intended as a primary residences. Speculative borrowing been stated as a contributing factor to the sub-prime mortgage crisis [8].

3.3 Securitization Practice

Asset securitization began with the creation of previous mortgage pools in the 1970s [9].

[7] Declaration of G20 (http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html)
[8] Louis Uchitelle (October 26, 1996). “H.P. Minsky, 77, Economist who decode lending trends.
[9] Asset securitization comptroller’s hand book (http://www.dallasfed.org/news/ca/2005/05wallstreet_asset.pdf)”

Securitization is a form of structured finance, whereby the asset been pooled as a collateral, for new financial asset issued by the entity (mostly GSE and investment banks) owing the underlying assets. Various parties involved in this transaction.

The traditional mortgage model, banks originate a loan to the borrower/homeowner and bank facing a credit or default risk. With the securitization, “originate to distribute” model is created, which is the credit risk is transferred or distributed to investors through MBSs and CDOs.

Securitization accelerated in the mid-1990s. The total amount of mortgage-backed securities issued almost tripled between 1996 and 2007, to USD7.3 trillion. The securitized share of sub-prime mortgages (i.e. those passed to third-party investor via MBSs increased from 54% in 2001, to 75% in 2006[10].

3.4 Failure of Credit Rating

Inaccurate high credit rating given to CDOs and MBSs based on sub-prime mortgage loans, without proper study by rating agency. These high ratings were believed justified because of risk reducing practices, including over-collateralization (pledging collateral in excess of debt issued), credit default insurance and equity investors willing to bear the first losses.

High rating encouraged investors to buy securities backed by sub-prime mortgages, push further the financing home loan activities. The reliance on an agency rating and the way rating used to justify investment led many investors to treat securitized products – some based on sub-prime mortgages – as equivalent to higher quality securities.

Critics alleged that the rating agencies running within conflict of interest, as they were paid by investment banks and other organization that organizes and sell structured

[10] Demyank, Yuliya: Van Hemert, Otto (2008-08-19). “Understanding the subprime mortgage crisis (http://papers.ssrn.com/s013/papers.cfm?abstract_id=1020396)”

securities to investors. On 11 June 2008, the Security of Commission (SEC) proposed rules designed to mitigate perceived conflicts of interest between rating agencies and issuers of structured securities [11].

3.5 Weakness of Government and Central Bank Policies

Current American regulatory framework is outdated, and its reported contributed to the crisis. As a speech by President George W. Bush in September 2008, “Once this crisis is resolved, there will be time to update our financial regulatory structures. Our 21st century global economy remains regulated largely by outdated 20th century laws” [12].

The vision and goal of the Clinton and Bush administration also contribute to the crisis factor. There is evidence that the Federal Government leaned on the mortgage industry, including Fannie Mae and Freddie Mac (the GSE), to lower lending standard [13].

In 1995, the GSE began receiving government incentive payments for purchasing mortgage backed securities which included loan to low income borrowers. Thus began the involvement of the GSE with the sub-prime market. Sub-prime mortgage origination rose by 25% per year between 1994 and 2003, resulting in a nearly ten-fold increase in the volume of sub-prime mortgages in just nine years. By 2008, the GSE owned, either directly or through mortgage pools the sponsored, USD5.1 trillion in residential mortgages, about half the amount outstanding [14].

Before the crisis, Central Bank manage the policy by focusing on rate of inflation and the lack of concentration with avoiding asset price bubbles, such as the housing bubble.

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[11] SEC Proposes Comprehensives Reforms to bring increased transparency to credit rating process (http://www.sec.gov/news/press/2008/2008-110.html)”.
[12] President’s Address to the Nation September 2008. (http://www.whitehouse.gov/news/release/2008/09/20080924-10.html)”.
[13] YT – Pressured to take more risk, Fannie Reached Tipping Point. (http://www.nytimes.com/2008.10.05/business/05fannie.html)
[14] Release Z.I., (http://www.federalreserve.gove/releases/ZI.current/zlr-4.pdf).

Central Bank look to choose to react after such bubbles burst so as to minimize collateral damage to the economy rather then taking effort to prevent the bubble itself.

4.0 IMPACT ON THE CRISIS

The crisis caused panic in financial market not only in U.S but globally, resulting investors taking money out of risky mortgage bonds and shifted to the other investment alternative such as commodities.

The crisis began to affect the financial sector in February 2007 when HSBC, the world's largest (2008) bank, wrote down its holdings of sub-prime related MBS by USD10.5 billion, the first major sub-prime related loss to be reported.

Beginning in mid-2008, all three major indices in the United States (the Dow Jones Industrial Average, NASDAQ, and the S&P 500) entered a bear market. On 15 September 2008, a slew of financial concern caused the indices to drop by their sharpest amount since the 2001 terrorist attack. That day the most note worthy trigger was declared bankruptcy if investment bank Lehman Brothers. Merrill Lynch also joined with Bank of America in a forced merger worth USD50 billion. Finally, concern over insurer American International Group's ability to stay capitalized caused that shock to drop over 60% that day. All these events culminated into a stock sell off that was experienced worldwide. Overall, the Dow Jones Industrial plunged 504 points (4.4%) while the S&P fell 59 points (4.7%). Not only U.S, European and Asian markets also experienced sharp drops.

The sub-prime crisis effects the economic globally. Declining house price have reduced household wealth and collateral for equity loans, which pressure on consumption and reducing purchasing power in the U.S. As the U.S is the one biggest country for Malaysia export, business trading, the sub-prime crisis will affect the Malaysia economic as well.

5.0 ISLAMIC FINANCING: A SOLUTION FOR SUB-PRIME CRISIS

The current sub-prime crisis which caused colossal financial loses running in billion dollars, would not occur if the Islamic principles regarding Collateralized Debt Obligation (CDOs) were in the international financial market.

Islamic banks do not relay on bonds or stocks, and are not involved in the buying or selling of debt unlike most conventional banks. Islamic banking is distinguished by the fact that it is prohibited from buying debts under Islamic law, therefore, Islamic bank are not affected directly from the global financial crisis.

According to Siddiqi, as far as the economic aspects of a person's life are concerned, the Quran does not hold any brief for a feudal, capitalist or socialist structure of society, or for any particular structure, for that matter, it give clearly defined values for an economic policies that conform to an Islamic way of life, irrespective of time and place [15].

In Islam, justice is one of the most important factors influencing the ideal Muslim society, for it covers every aspect of human interaction; social, economic and political. Regarding economic and business transaction, Islam emphasis on establishment of justice. The prohibition of riba and gharar is clearly stated in Islamic teaching from Quran and Sunna, and it is generally accepted by the schools of thought in the shariah[16].

Islamic stipulate the rules and principle that should adhered in business dealing and financing, which are summarize as follows;

i. **Any predetermined payment over and above the actual amount of principle is prohibited;** Islam allows only one kind of loan and that is qard-

[15] Muhammad Nejatullah Siddiqi, Some aspect of the Islamic economy (Delhi: Markazi Maktaba Islami, 1972) pp 135-137.

[16] Nabil A.Saleh, Unlawful gain and legitimate profit in Islamic law: Riba', gharar and Islamic banking (Cambridge, UK: Cambridge University Press, 1986) pp1-13.

al-hassan, whereby the lender does not charge any interest or additional amount over the money lent,

ii. **The lender must share in the profit or losses arising out of the enterprise for which the money was lent;** Islam encourage Muslim to invest their money and become partners in the business instead of becoming creditors. As define in the shariah/Islamic law, Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are manufacturing sector, construction, services etc. Translated into banking terms, the depositor and the borrower should all share the risks and the reward of financing business ventures.

iii. **Making money from money is not Islamically applicable;** In Islam, money is only a medium of exchange – i.e. a way of defining the value of a thing, therefore should not be allowed to give rise to the money via fixed interest payment by being put in a bank or lent to someone else. In Islam, human effort, initiative and risk involved in a productive venture are more important than the money used to finance it. In related to the matter, Islam also prohibited trading in debt.

iv. **Gharar (uncertainty, risk or speculation) is also prohibited;** In Islam, any business dealing entered should be free from uncertainty, risks and speculations. Contracting parties should have perfect knowledge of the counter values intended to be exchange as a result of their transaction. Therefore, option and futures are considered as un-islamic and so are forward exchange transactions because rates are determined by interest differentials.

v. **Investment should only support practices or products that are not forbidden;** Any transaction activities restricted in Islam and was not approved by shariah law is prohibited. For example, Islamic bank cannot extend the financing for alcohol trading, construction of casino, gambling and speculation activities or any other prohibited activities.

Here are simple comparisons on lending practice between conventional and Islamic baking related to the risk.

Items	Commercial Banking	Risk	Islamic Banking	Risk
Lending	Without asset back, securitization practice	High	Asset back	Low
Speculation	allowed	High	Prohibited	Low
Debt trading	allowed	High	Prohibited	Low
Type of lending	Lending of money / usury	High	Based on profit sharing	Low
Forbidden product	Not prohibited for financing	High	Prohibited for lending	Low

6.0 RESIDENTIAL PROPERTY FINANCING IN ISLAMIC BANKING

Conventional Banking which are offers the residential property financing through lending the money, that later the system also created an “innovation” financing packages via securitization by selling debt mortgages that created from a few layers of financing. However, Islamic banking have their own way to offers residential property which is called Al Bai Bithaman Ajil (BBA) and Musyarakah Mutanaqisah (MM). The write up below is focus on residential financing offers by Islamic banking in Malaysia contact.

6.1 Overview of early Islamic consumer financing in Malaysia

In Islam there is a clear prohibition of riba but the contract of exchange or Al-Bai or sale is declared to be legitimate. Although the contract of exchange, traditionally and conventionally, is not financing in character, it has been actively deployed as one of the major instruments for Islamic financing worldwide. Hence, one of the clear differences between Islamic banking and conventional banking transactions is that Islamic banking transactions are predominantly based on buying/selling or contract of exchange whereas conventional transactions are based on lending contracts

6.2 Bai Bithaman Ajil the premier consumer financing facility in Malaysia

BBA facility enjoys a dominant role in the Malaysian financing market and widely recognized as the primary mode of Islamic consumer financing in Malaysia. The impact of BBA to consumer financing in Malaysia is especially significant in the Islamic home financing sector where BBA has the huge share of the market.

6.2.1 What is Al-Bai' Bithaman Ajil (BBA) House Financing?

BBA House Financing is an Islamic house financing facility, which is based on the Syari'ah concept of Al-bai Bithaman Ajil (BBA). 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. Profit is in this context is justified since it is derived from the buying and selling transaction as opposed to interests accruing from principal lent out.

6.2.2 What are the main characteristics of a BBA House Financing?

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.

6.2.3 How to compute the Selling Price in BBA?

Selling price is compute as below formula;

Selling Price = (Monthly Installment x Number of Financing Months) + Grace Period Profit (if any)

Notes:

- Monthly installment is computed using the agreed profit rate on a Constant Rate of Return and monthly rest
- Grace Period Profit is charged when Bank is financing property under construction. As such, during the construction period, customer will pay the grace period profit only

Example:

Customers buy from developer/Seller	: RM200, 000
Deposit pay	: RM20, 000
Financing Amount (Purchase Price)	: RM180, 000
Profit Rate	: 8.00% p.a
Financing Period	: 25 Years (300 months)
Installment per month	: RM1, 390

Selling Price = (RM1389.269 x (25x12) + 0 = RM416, 780.00

Explanation:

The client or customer buy the property with developer/seller at RM200, 000 and pays a deposit ("Arboon") RM20, 000 (which is normally 10% of the property selling price offered by the developer/seller). The customer then seeks a bank's financing facility at RM180, 000 to complete the purchase. Under the property purchase agreement (PPA) the bank buys the property from the customer at RM180, 000 (i.e. 90% of the remaining purchase price of the property) which the bank pays directly to the developer/seller. Simultaneously, the bank and the customer sign a property sale agreement (PSA) whereby the bank sells back the property to the customer at a mark-up ("profit") on deferred payment by the customer – i.e. at RM416, 789 (with the profit rate at 8.00% p.a and loan tenure 25 years @ 300 months).The difference of RM236, 780 (RM416, 780 – RM180,000) is the total profit for the Islamic bank from this transaction.

The success of BBA in Malaysia is unsurprising as the Malaysian population is of Muslim majority. With the competitive pricing offered by Islamic financing institutions compared to conventional financiers, Islamic home financing has broadened its appeal to non-Muslims as well. While the BBA is widely used in Malaysia, Indonesia, Brunei and a few other countries, it has been subjected to much controversy among Islamic scholars worldwide with regard to its permissibility; with most of the Middle East scholars rejecting it.

BBA is actually an extension of the Murabahah (cost plus) contract and share the same roots. Both financing facilities employ the deferred payment scheme whereby the commodity exchanged is delivered immediately but the sale price (with profit) is paid in installments over a period — for BBA it is a longer period and for Murabahah, it is generally a shorter period.

6.2.4 What is the difference between BBA house financing and ordinary conventional housing loan?

An ordinary conventional housing loan is given on the basis of debtor/creditor relationship. Whereby, the amount of loan is being charged interest, normally quoted at a certain percentage above Base Lending Rate (BLR) over loan period, repayable in periodic installment. The BLR will fluctuate up or down and it will affect the total loan cost. Simultaneously, arrears in conventional loans are normally capitalized.
However, under Islamic banking scheme, since BBA concept is being applied, 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.

7.0 CRITICISMS ON BBA FINANCING

7.1 Similarity to conventional loans

In the conventional system, home financing is of course usually interest-based and forbidden in Islam but the current BBA home financing is not much different. Instead of charging the customer interest, the Islamic financier charges a profit derived through a buy-and-sell contract but regretfully, the profit rate is dependent on the market interest rate due to arbitrage activities. Therefore, while the BBA is practiced as Shariah compliant in some countries, it is nonetheless similar to the conventional mode with the profit rate tracking the market interest rate. Some jurists even consider the BBA concept to be a means to circumvent the prohibition of charging interest rates rather than being a different concept altogether.

7.2 BBA as an actual contract of exchange

Under the BBA concept, the bank is required to hold ownership of the asset and therefore all liabilities as well. But the legal documentation indicates that the bank's role as actual owner is not definitive. Hence the similarity with conventional financiers who are free from liabilities. Initially the common practice of Islamic banks was to provide for notations agreements in the BBA financing documentation which make it clear that the bank purchases the asset from the vendor and subsequently sells it to the customer. However, this practice is currently discontinued due to operating difficulties faced by the bank on the issue of liability.

7.3 BBA financing tenure

One of the biggest criticisms against BBA is on the terms of tenure which critics consider to bring hardship to the customer. Under the current BBA concept, the profit margin as predetermined by the bank is fixed for the entire duration of financing and the profit margin is capitalized upfront unlike under conventional financing. Hence customers wanting to redeem the balance of financing before the expiry of the financing period find that the amount is far higher than in conventional financing. However, Islamic banks are known to give rebates for early repayment but the amount is not mentioned in the financing documents and is at the absolute discretion of the bank.

7.4 Default in payments

The current BBA financing has attracted controversy with regard to the amount of payment of the financing in the event of a default by the customer. The legal documentation provided by most banks to facilitate the BBA financing provides for the customer to settle the whole selling price inclusive of the profit margin which is capitalized upfront. Critics consider the profit margin claimed by the bank for the entire financing tenure after termination of the BBA on default as unwarranted and unjustifiable. Moreover, Malaysian courts have ruled against such practice.

8.0 MUSHARAKAH MUTANAQISAH - THE FINANCING INNOVATION FOR RESIDENTIAL PROPERTY IN ISLAMIC BANKING

Capitalist banking system have their own way for financing Innovation – that is called "securitization" . Islamic Financing, also have the own way on financing innovation for the residential property – which is called Musharakah Mutanaqisah (MM).

The term "Musharakah" is derived from the Islamic fiqh concept of "Shirkah" which means sharing or partnership. There are basically two main types of Musharakah:

- Shirkat-ul-Milk: joint ownership by two or more persons or parties in a particular property or asset.
- Shirkat-ul-Aqd: a contract between two or more persons or parties on a common business objective. The sole purpose is to share profits and losses arising from a jointly owned enterprise in line with the Shariah.

8.1 Nature of Musharakah financing

A form of partnership between the Islamic bank and it clients whereby each party contributes to the capital in equal or varying degrees to establish a new project or share an existing one, and whereby each party becomes an owner of the capital on a permanent or declining basis and have a due share of profits. Losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.

8.2 Types of Musharakah financing

a) Constant Musharakah — the partners' share in Musharakah capital remains constant throughout the period; and

b) Musharakah diminishing to ownership — one party has the right to purchase the other party's share which declines until one become the sole proprietor of all the capital (Musharakah Mutanaqisah).

Diminishing Musharakah/Musharakah Mutanaqisah:

This is a Musharakah/partnership in which the Islamic bank agrees to gradually transfer to the other partner its share in the Musharakah so that the Islamic bank's share declines and the other partner's share increases until the latter becomes the sole proprietor of the venture.

MM is a partnership contract where the bank and customer form a partnership to purchase a certain asset with the bank's share diminishing on the gradual payment by the customer. The MM financing concept can be illustrated thus:

- The customer enters into a partnership agreement with the bank for the purchase of an asset for example, buying the house..
- The customer makes a payment for the initial share, e.g. 10%, for co-ownership with the balance of shares provided by the bank.
- The bank immediately leases its 90% share under the Ijarah concept where the customer agrees to pay rental for the lease.
- The customer subsequently redeems the bank's share by payment of the rentals in installments as agreed upon in the MM contract. The rent payable to the bank also reduces proportionately.

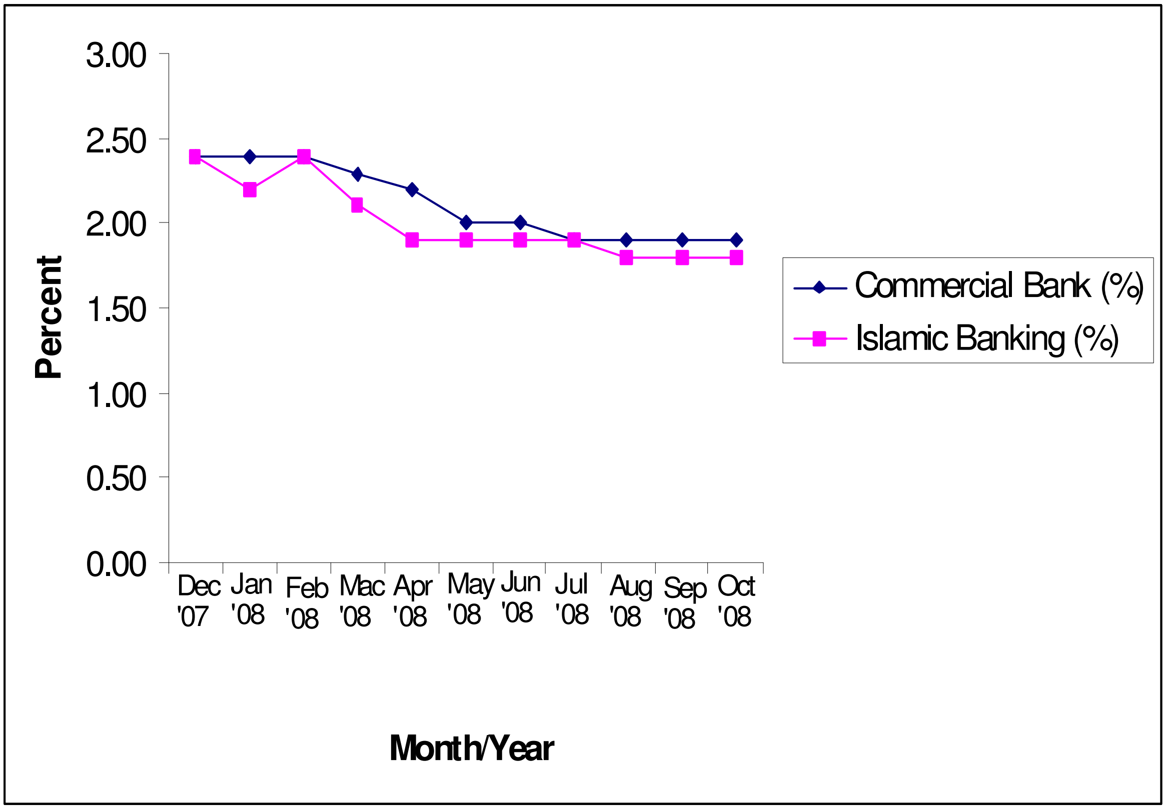
- The customer's share gradually increases upon each periodic rental payment until eventually the asset is fully owned by the customer and the bank's share is entirely diminished.

9.0 CAPITAL RAISING

In case the business that require capital or that need venture capital, the Islamic System providing finances is called mudarabha. From this system, the bank or the individual provides the financing and the person receiving the fund provides his entrepreneurial skills. Profit or loss from the business is shared on tan agreed basis.

Arrangement regarding car's leasing is called ijara. This system is more or less same as the Western banking system and with an option to buy the leased car is called Ijara Wa Iqtiana. The recent development of "Bonds" transaction, called sukuk based on equity participation – is gaining popularity in some Middle East countries. As we can see the process involved requires socially responsible investing in worthy causes and especially that would benefit the society.

10.0 COMPARISON OF NON PERFORMING LOAN (NPL) : COMMERCIAL BANKS AND ISLAMIC BANKING FROM DEC 2007 – OCT 2008



Source: Bank Negara Malaysia

From the graft, shows the NPL of Islamic banking is consistently lower than NPL commercial bank (based on 6 months NPL – study from the month of Dec 2007 until October 2008). This statistic can be translated that Islamic banking having a better asset quality compared to commercial banking.

From the study, the reasons of lower NPL in Islamic banking compared to conventional banking can be summarized as follows;

i. **Price of Loan :** For conventional financing, price of loan or interest rate can up and down depending on Base Lending Rate (BLR). During economic crisis, the price of financing (loan) in conventional system usually higher. However in Islamic financing, the nature of determination of profit is fixed, as such the monthly repayment is fixed and will not goes up even though the BLR go up. The fixed repayment element also will make convenience to customers in terms of monthly budgeting. OR

ii. **Risk of Sharing Concept :** Among the Sharing concept in Islamic financial system are as follows;

Mudharabah – i.e a contract between a capital provider/lender (Sahibul Mal) and entrepreneur (Mudarib) in which the lender contributes the capital and the entrepreneur contribute the effort in managing the business. However, if the business incurs loss, it shall be born by the lender alone, which the entrepreneur would have wasted his time and efforts.

Musharakah - In Islam, Musharakah means a joint enterprise formed for conducting Some business in which all partners share the profit and loss according to a specific ration.

Based on business relationship between lender and entrepreneur in Islamic financing as mentioned above (especially in Musharakah system), its created a win-win situation and each party will do their best to ensure the operation of business is successful to enable them to enjoy a maximum proportionate profit as agreed. Compared to conventional financing, the lender only waiting and demanding on monthly repayment by collecting the interest via the money that they lend out and ignoring the actual meaning of business. OR

iii. **Integrity of Borrowers:** The borrowers try to avoid sins as the debt is compulsory to paid in Islam. In fact, Islam permits debt within affordable limits. However, if debts are incurred, the borrower must responsible for prompt and full repayment. The

Prophet Muhammad (s.a.w) said *" the best among you are those best in paying the Debts"* (reported by Muslim) and *"procrastination" (delay in repaying debts) by* wealthy *person is injustice* (reported by Bukhari). Another hadith states *" Whoever contracts a debt intending to repay it, Allah will repay it on his behalf, and whoever contracts a debt and intending to waste it, Allah will bring him to ruin"* (reported by Bukhari). These hadith emphasis on contracting debt and warn against acquiring debt that one does not have the means or intention to repay. By then, the Muslim borrowers try to avoid the sins and fulfill the requirement by hadith as one of '*rukun Iman*' in Islam is believe in Al Sunnah (hadis). OR

iv. **Combination of i, ii, iii above**.

However due to strengthening loan process via implementing proper risk management unit by commercial bank, couple with comprehensive guideline and procedures from Bank Negara Malaysia, the NPL gap between commercial banks and Islamic banks is not too huge, as shown in the graft above.

11.0 CONCLUSION

Sub-prime crisis is created by capitalis financing system which is consist unhealthy element such as speculation which is avoid the real meaning of trading that need to backed by asset. Comparing with Islamic financing system, which incorporate principles of Shariah or Islamic Law, it has avoided the kind of disaster that is currently absorbing world market. Islamic principles prohibits the payment and collection of interest, which is seen as for gambling, so highly complex instruments such as derivaties and other creative accounting practices are banned. Transaction must be backed by real asset, thus avoiding repackaged sub-prime mortgages, and because risk is shared between the bank and the depositor there is an incentive for the institutions to ensure the deal is sound. The credit rating under Islamic banking and finance evaluates real term business potential and growth trends, instead of evaluating manipulation asset value which causing damages to the credit market. Thus the regulators and credit rating agencies should now adopt principles of Islamic financing to safeguard the financial sector from anymore crisis.

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