



Challenges in Implementing Musharakah Mutanaqisah Islamic Home Financing in Malaysia

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Abstract: This study aims to identify the challenges surrounding the implementation of Musharakah Mutanaqisah Islamic home financing in Malaysia. Despite it is more Shariah compliant than other products such as Bay Bithaman Ajil home financing, Musharakah Mutanaqisah home financing is still not in favor of the Islamic banks in Malaysia when they structure their mortgages. This study employs library/literature based method which is a kind of qualitative research methodology. Relevant literature is selected from available databases using convenience sampling technique. Using inductive approach, the study reveals that there are 9 major challenges that hinder the implementation of Musharakah Mutanaqisah home financing by Islamic banks in Malaysia. The identified challenges are (1) Ownership issue; (2) Legal framework; (3) Repayment issue and default; (4) Client's unwillingness to share the profits and the tax issue; (5) Risk of loss; (6) Secrecy of the business; (7) Dishonesty and moral hazard; (8) Awareness of the Mortgage Products; and (9) Rental rate benchmarking. This study is expected to help Islamic banks in Malaysia in setting up internal strategy, policies and procedures to tackle the identified challenges. The study also can be an input for Islamic banks' regulator in this case Bank Negara Malaysia (BNM) to set up rules and regulation to ease the implementation of MM home financing by Islamic banks in Malaysia. Mortgage clients in Malaysia also can use this study in helping them to understand the concept of MM home financing well and to be aware of the reasons why MM is preferable by Shariah scholars than BBA home financing.

Keywords: Islamic Housing Finance, Challenges, Musharakah Mutanaqisah, Malaysia

1. INTRODUCTION

Amongst the three most basic necessities for human being to live in this world with ease, housing ranks third (3rd) following food and clothing. Housing has a direct effect on human lives for example in terms of health, culture and self-respect. In Islam, fulfilling the basic necessities including housing is one of the objectives of Shariah (Maqasid Al-Shariah). However, given the huge amount required to buy a house, most people end up in taking financing in order to buy a house.

Due to the prohibition of Riba in Islam, conventional home loan offered by conventional banks, which contains Riba, is considered to be Haram (prohibited) for Muslims. Alternatively, Islamic banks



offers variety of Islamic home financing schemes or Islamic mortgages to the consumer, corporate companies as well as to the large investment houses. The debt based financing i.e. Murabaha, Bay Bithaman Ajil (BBA), Ijarah, Istisna and equity based financing i.e. Musharakah Mutanaqisah (MM) or Diminishing Partnership.

It is essential to mention here that many scholars with respect to debt based financing (BBA) alleges that it is similar to conventional home loan and even resulting in higher financing costs in case of early repayment, therefore, equity based product for home financing (MM) is preferable (Meera and Abdul Razak, 2005; Meera and Abdul Razak, 2009; Osmani and Abdullah, 2010). However, even though MM is more favorable than BBA by the Shariah scholars, BBA is still the dominant contract used by Islamic banks in Malaysia (Abdul Razak and Taib, 2009). This has raised a question “what are the challenges faced by Islamic banks in Malaysia in implementing the MM home financing?” For that reason, it is important to identify the challenges in order to find solutions to the issue.

Based on the above background, this study aims to identify the challenges faced by Islamic banks in Malaysia in implementing Musharakah Mutanaqisah (MM) home financings based on the available literature related to the subject. This study is expected to help Islamic banks in Malaysia in setting up internal strategy, policies and procedures to tackle the identified challenges. The study also can be an input for Islamic banks’ regulator in this case Bank Negara Malaysia (BNM) to set up rules and regulation to ease the implementation of MM home financing by Islamic banks in Malaysia. Mortgage clients in Malaysia also can use this study in helping them to understand the concept of MM home financing well and to be aware of the reasons why MM is preferable by Shariah scholars than BBA home financing.

2. LITERATURE REVIEW

This section is divided into 2 subsections namely the concept of MM and previous studies about MM home financing.

2.1 Concept of MM Home Financing

Musharakah Mutanaqisah (MM) or Diminishing Partnership is relatively new but started to gain popularity amongst Islamic financial institutions. It is generally argued that MM is closer to the spirit and objectives of Shariah and should therefore be used more often by Islamic financial institutions (Meera and Abdul Razak, 2005; Meera and Abdul Razak, 2009; Osmani and Abdullah, 2010). MM home financing is a derivative of Musharakah/Shirkah contract. One of the benefits of MM can be traced from its root contract Musharakah/Shirkah. MM is based on Shirkat al-Milk (joint ownership) and **“is the combination of assets of two or more persons in a manner that creates a state of sharing in the realized profit or income or benefiting from an increase in the value of the partnership assets. This combination of assets for making profit necessitates losses, if any. This partnership is created by the wish of the partners such as when two or more parties acquire common shares in a particular asset”** (Lahsasna, 2013). This aspect obviously creates a religious appeal in the eyes of Shariah conscious clients which will help Islamic banks in enhancing their images. This is because MM home financing which uses profit sharing arrangement is considered as more justice than debt based financing such as BBA home financing by Shariah scholars (Meera and Abdul Razak, 2005; Abdul Razak and Md Taib, 2009; Osmani and Abdullah, 2010).

In term of economic benefits, it is also found that MM home financing is cheaper for the customers than BBA home financing (Meera and Abdul Razak, 2009). In addition, unlike in the case of BBA home financing, the outstanding balance of MM financing will never be more than the original price of the asset (Aris et al., 2011). Thus, it is expected to attract more customers to deal with Islamic banks

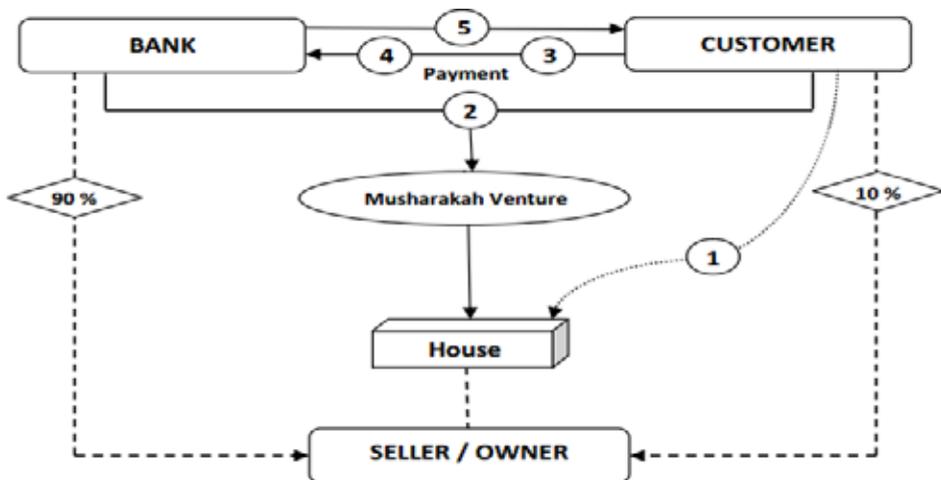
in the future.

The Shariah validity of the underlying contracts in MM was found in the Quran, the Prophet Mohammad’s (peace be upon him) Sunnah and Consensus of the Muslim scholars (Ijma). Muslim jurists were unanimous in approving this contract. When combined into a product structure, however, there were certain conditions and rulings that needed to be fulfilled for Shariah compliance. The Islamic Fiqh Academy of OIC issued a resolution in 2004 that stated that MM was a permissible product structure “if it is practiced according to its actual parameter” (Usmani, 2004).

According to AAOIFI Shariah Standards, it was permissible in Shariah to combine more than one contract in one set, without imposing one contract as a condition on the other, and provided that each contract was permitted on its own. This type of contract combination was acceptable unless it fell afoul of a Shariah restriction that led to it being banned on an exceptional basis (AAOIFI, 2010).

The MM model could be easily implemented for various financing purposes, including: housing projects, car financing, financing of working materials and equipment, and financing business projects. Basically, MM home financing can be structured using the following steps:

1. Customer identifies the property; sign Sales and Purchase (S&P) agreement; pays deposit; and applies for financing
2. Bank, once application is approved, enters into a Musharakah Arrangement with customer.
3. Customer leases the bank’s share in the house.
4. Customer will pay an amount in addition to the rental to buy the Bank’s units in the property.
5. The partnership will be terminated with the customer owning 100% of the house; the title will be transferred to him. Figure 2.1 below summarizes the steps involved in structuring MM home financing.



Source: Haneef et.al (2011)

Figure 2.1: The Structure of MM Home Financing

2.2 Previous Studies about MM Home Financing

There are various research papers that discuss MM home financing. Meera and Abdul Razak (2005)



conduct a comparative conceptual analysis between BBA home financing and MM home financing. Using library based method which is a kind of qualitative research method, the study finds that overall MM home financing is more superior than BBA home financing according to Shariah. This is because Shariah scholars are in the consensus on the permissibility of the MM home financing while only several scholars permit the BBA contract. In addition, MM home financing is cheaper than BBA home financing. It is also important to note that in MM home financing the balance of financing, at any point in time, never exceeds the original price of the asset. On the other hand, it is possible to happen in BBA home financing.

Abdul Razak and Md Taib (2009) examine Islamic banks' customers' perception on MM home financing as compared to BBA home financing. The study conducted a survey using questionnaire distributed to 300 home owners and potential owners in Malaysia asking them on the concept, pricing, justice, profit computation method, Shariah compliant, societal wellbeing, and their preference. The results of the survey reveal that majority of the respondents are dissatisfied with the BBA home financing and believe that BBA home financing has several issues in terms of concept, pricing, justice, profit computation method, Shariah compliant, and societal wellbeing. The respondents are also in the opinion that MM home financing which uses profit sharing arrangement to be more justice than BBA home financing.

In another study, Meera and Abdul Razak (2009) identify several practical issues related to MM home financing. Through extensive literature and scholars' opinion, the study reveals that the rental rate computation, issues on tax, defaults and revaluation of property as the practical issues that need to be tackled by Islamic banks in order to increase the share of MM home financing. The study also finds that in average the rental rates are lower than the interest rates in Malaysia during 1984-2005 which suggest the MM home financing might be not that much interesting for Islamic banks to implement. Therefore, the study suggests for the implementation of MM home financing through cooperative scheme.

Osmani and Abdullah (2010) examine the implementation of MM home financing in Malaysia from Islamic jurisprudence (fiqh) perspective and compare it with other home financing contracts such as BBA. Using extensive literature which is a kind of qualitative research approach, the study adopts a critical analysis method to examine whether the current practice of MM home financing among the Islamic banks in Malaysia has already been confirmed to Shariah or not. The study finds that there are some shortcomings in the implementation of MM home financing in terms of legal rules related to Islamic banking contracts, tax, ownership. However, overall MM home financing is still better than other home financing contracts such as BBA from Shariah perspective and therefore it should be the Islamic banks' choice.

Smolo and Hassan (2011) provide a theoretical overview on the potentials of Musharakah Mutanaqisah for Islamic home financing. Using extensive literature review, the study finds that MM home financing is more in line with Shariah than other Islamic home financing contracts such as BBA and Murabaha home financings. In addition, it is also found that MM home financing is cheaper for the customers than BBA home financing. Therefore, the study urges Islamic banks to use MM home financing more from time to time. Aris et.al (2011) also compare between BBA home financing and MM home financing using conceptual analysis approach. Using extensive literature review, the study also concludes that MM home financing is better than BBA home financing from Shariah perspective. It is argued that MM home financing is more in line with the objectives of Shariah since it promotes the welfare of the people as the outstanding balance of financing will never be more than the original price of the asset.

Hanafi (2012) identifies issues and challenges in the implementation of MM home financing in



Malaysia especially those issues that are related to legal and Shariah. Combining interviews with survey questionnaire, the study finds that there are several issues that deter the development of MM home financing in Malaysia. The issues are inadequate legal framework, treatment in the event of default, non-standardized agreement, issue of ownership, and Shari'ah issues such as issue of rental benchmarking. The study also finds that the level of customers' awareness on Islamic mortgage products in Malaysia is still very low.

3. RESEARCH METHODOLOGY

This section has 3 subsections namely research design, research method and approach and data collection.

3.1. Research Design

Research design can be defined as the overall strategy adopted by a study in order to address the research problem (Cooper and Schindler, 2013). There are several types of research design namely descriptive, correlational, experimental, review, and meta-analytic (Jalil, 2013). This study uses review type of research design particularly traditional literature review. In this type of research design, extensive available literature are reviewed and used to achieve the objective of the study. This type of research design has been used by most of the previous studies in the area of MM home financing (Meera and Abdul Razak, 2005; Meera and Abdul Razak, 2009; Osmani and Abdullah, 2010; Smolo and Hassan, 2011).

3.2 Research Method and Approach

There are 2 types of research methods namely quantitative and qualitative research methods (Cooper and Schindler, 2013). While quantitative research method uses quantifiable data to explain facts and reveal patterns in research, qualitative research method gives a comprehensive description and analysis of the research subject using textual data format (Jalil, 2013). This study uses library or literature based method which is a kind of qualitative research method. This method has been employed by most of the previous studies in the area of MM home financing (Meera and Abdul Razak, 2005; Meera and Abdul Razak, 2009; Osmani and Abdullah, 2010; Smolo and Hassan, 2011). With regards to the research approach, this study employs inductive research approach where the researcher starts the research by observing specific subject and draws generalized conclusions from the observation. This approach is commonly used in most qualitative research.

3.3 Data Collection

The study uses secondary sources of data. Available related literature are gathered and reviewed to achieve the objective of the study. Researcher accesses the available databases to collect the relevant studies. The population of the study is all previous studies related to Musharakah Mutanaqisah home financing in Malaysia. Convenience sampling technique is used by the researcher to gather the data where available literature related to MM home financing in accessible databases have been selected by the researcher as the sample of the study. Convenience sampling technique is a non-probability sampling technique where the subjects are selected based on their accessibility to the researcher (Cooper and Schindler, 2013). The literature used as the sample consists of journal articles, international conference proceedings, and books that discuss the issues and challenges in the implementation of MM home financing. Those sources are used to achieve the research objective.

4. DISCUSSION

This section discusses the findings of the study. Identified challenges to the implementation of MM home financing in Malaysia are elaborated based on the available literature. Available literature reveals



that there are at least 9 major challenges that need to be tackled in order to ease the implementation of MM home financing by Islamic banks in Malaysia. The identified challenges are (1) Ownership issue; (2) Legal framework; (3) Repayment issue and default; (4) Client's unwillingness to share the profits and the tax issue; (5) Risk of loss; (6) Secrecy of the business; (7) Dishonesty and moral hazard; (8) Awareness of the Mortgage Products; and (9) Rental rate benchmarking (Usmani, 2004; Meera and Abdul Razak, 2009; Osmani and Abdullah, 2010; Hanafi, 2012). Each identified challenge is further discussed in more details in the following subsections.

4.1 Ownership Issue

One of the legal issues in Musharakah financing is ownership issue (Osmani and Abdullah, 2010; Hanafi, 2012). Current policies are not supportive to register the property for the bank and the partner together which results the ownership lies with the customer normally. In this case, the bank remains as a beneficial owner and the profit of the bank is secured by creating a lien on the property. This norm has been followed by many Islamic banks in Malaysia other than Kuwait Finance House (KFH) whereby the legal status of the property registered in the name of KFH which holds the property on trust to the customer. This matter requires further research by examining the reason behind this policy.

4.2 Legal Framework

In Malaysia, current legal framework is not satisfactory for MM instruments since the MM products are equity in nature hence it is not meeting the Shariah requirements. Moreover, the present practice stays uncertain as there is no point of reference and no single case has so far been brought in the court of law on the legality of such practices (Meera and Abdul Razak, 2009; Osmani and Abdullah, 2010; Hanafi, 2012). In other words, there is no legal precedent that can be used as a reference for any legal case. Therefore, improvement in legal framework in Malaysia is still needed to ease the implementation of MM home financing. Bank Negara Malaysia (BNM) as the regulator should pay attention to this aspect

4.3 Repayment Issue and Default

Repayment is another issue between the banks and customers which requires the banks to reassess the methods of recovery in the cases of default (Meera and Abdul Razak, 2009; Hanafi, 2012). Many Islamic banks are still mirroring the conventional bank's techniques for financing recovery. Currently, all the Islamic banks are following two methods in a situation where customer is unable to pay back the financing amount at all. In the first method, the banks sell out the property in the market through auction in order to recover the financing amount. However, in some cases, the amount received through auction is not enough to settle the financing amount. In this situation, banks put pressure on the customer to settle the amount since the customer has put waa'd (purchase undertaking at par). This should not be the case, and it is totally malpractice by the banks, ethically, morally and it is incorrect from the Shariah perspective as well. In the second method of repayment, the banks bears the losses and do not look for any recourse from the customer. The second repayment method of settling the financing amount is more Shariah compliant than the first method as the financing agreement is based on Musharakah, therefore, banks, instead of putting pressure on the customer or looking for recourse from the customer, they are expected to bear and share the loss along with the customer in the event the property is sold undervalued

4.4 Clients' Unwillingness to Share the Profits and the Tax Issue

Clients' unwillingness to share profit is yet another concern raised in Musharakah financing. It is mentioned that the clients are not willing to share with the Banks the actual profits of their business. The reluctance is based on two reasons:



1. They think that the bank has no right to share in the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business and why they should share the fruits of their labour with the bank who merely provides funds. The clients also argue that conventional banks are satisfied with a small rate of interest and so should the Islamic Banks (Usmani, 2004).
2. Even if the above was not a factor, the clients are afraid to reveal their true profits to the Banks, lest the information is also passed on to the tax authorities by the banks and clients' tax liability increases (Meera and Abdul Razak, 2009; Osmani and Abdullah, 2010; Hanafi, 2012).

The way out for the first part, though not easy, is not difficult or impossible either. Such clients need to be convinced and persuaded that borrowing on interest is a serious sin, unless there is a dire necessity for such borrowing. Mere expansion of business is not a dire need by any stretch of imagination. By making a legitimate arrangement for obtaining funds for their business, by way of *Musharakah*, not only do they earn Allah's pleasure but also a legitimate return for themselves, as well as for the Islamic Banks.

In respect of the second factor, it is the obligation of the client to pay tax to the government and it is the duty of the government to ensure that the rates imposed on the citizens are appropriate. In addition, the governments should also try to appreciate the fact that if rates of taxation are reasonable and if the tax-payers are convinced that they would benefit by honestly paying their taxes, this would increase and not decrease government revenue.

4.5 Risk of Loss

It is argued that the arrangement of *Musharakah* is more likely to pass on losses of the business to the financier (e.g: bank or non-bank financial institution). Subsequently, this loss would be passed on by the financier to their depositors since the depositors are the *rab almal* in *mudharabah* contract. The depositors, being constantly exposed to the risk of loss, would not want to deposit their money in the banks and financial institutions and thus their savings would either remain idle or would be used in transactions outside of the banking channels, which would not contribute to the economic development (Usmani, 2004).

This argument is, however, misconceived as before financing on the basis of *Musharakah* takes place, the banks and non-bank financial institutions would usually study the feasibility of the proposed business for which funds are needed. Even in the present system of interest-based loans, the banks do not advance loans to each applicant until the viability of the financing project is assured. In *Musharakah* financing, a similar procedure would have to take place in order to ensure the feasibility of the project and avoid any possible loss. In fact, more thorough feasibility studies would be pertinent to mitigate the risk of investment (Usmani, 2004).

4.6 Secrecy of the Business

Another concern which is related to making the financier a partner in the business of the client is the partner may disclose the secrets of the business to the financier, and subsequently the secret will be passed through the bank to other traders. This concern can be overcome by requesting the insertion of certain conditions in the *Musharakah* agreement. In fact, the client, while entering into the *Musharakah*, may place a condition that the financier would not interfere with the management affairs, and he would not disclose any information about the business to any person without prior permission of the client. Such agreements of maintaining secrecy are always honored by the prestigious institutions, especially by the banks and financial institutions whose entire business is based on confidentiality (Usmani, 2004).



4.7 Dishonesty and Moral Hazard

Dishonesty is another hesitation in the sense that dishonest clients or partners may exploit the instrument of Musharakah by not paying any return to the financiers or do not disclose the actual profits of the business. They can always show that the business did not earn any profit. Indeed, they can claim that it has suffered a loss in which case not only the profit, but also the principal amount would be jeopardized.

4.8 Awareness of the Mortgage Products

Most of the Islamic banks in Malaysia are focused on BBA mode of transaction for mortgages for the past three decades while MM home financing was launched in the market around 12 years back and people having less awareness due to lack of expertise in the field (Hanafi, 2012). It has been known that awareness level can be enhanced through education. Government of Malaysia especially Bank Negara Malaysia (BNM) is realizing it and working hard to build Islamic banking knowledge system for the people of Malaysia in order to enhance their awareness level on Islamic finance products. INCEIF is one of the fine examples of the BNM's efforts where most of the students are becoming agents of changes in the field.

4.9 Rental Rate Benchmarking

Available literature reveals that in practice some banks use interest rate as the benchmark for MM home financing rental rate (Meera and Abdul Razak, 2009; Hanafi, 2012). Even though many scholars argue that there is no harm in using interest rate such as Kuala Lumpur Interbank Offered Rate (KLIBOR) as the benchmark in determining MM home financing, there are also concerns regarding the practice. However, some also argued that using interest rate as the benchmark for MM home financing might unveil Gharar since it is extremely difficult to predict the future changes in the interest rate.

In addition, the validity of the lease contract in MM home financing becomes doubtful since one of the requirements in Ijarah is that the lessor cannot unilaterally changes the rental. In the case of the usage of KLIBOR as the benchmark, when the KLIBOR increases, the rental will be adjusted accordingly. This practice creates ambiguity and contains Gharar (Meera and Abdul Razak, 2009). Using average market rental rate or property index is suggested in order to fully eliminate the Gharar.

5. CONCLUSION AND RECOMMENDATIONS

This section concludes the study and comes out with several recommendations in order to address the identified challenges.

5.1 Conclusion

As housing is one of the basic necessities of human being, Islamic banks have come out with several Islamic mortgage products in order to help Shariah conscious clients to fulfill their dreams. This situation also applies in Malaysia. It has been highlighted by many studies that comparing the practice of Musharakah Mutanaqisah home financing with BBA home financing in Malaysia, it has been found that MM home financing is more shariah compliant than BBA home financing. However, until today, BBA home financing is still the first choice of Islamic banks in Malaysia when structuring their mortgage. This has motivated the researcher to identify the challenges that hinder the implementation of MM home financing in Malaysia. Using extensive available literature, the study managed to fulfill its objectives by highlighting 9 major challenges that faced by Islamic banks in Malaysia in implementing MM home financing.



The 9 identified challenges are (1) Ownership issue; (2) Legal framework; (3) Repayment issue and default; (4) Client's unwillingness to share the profits and the tax issue; (5) Risk of loss; (6) Secrecy of the business; (7) Dishonesty and moral hazard; (8) Awareness of the Mortgage Products; and (9) Rental rate benchmarking. Those challenges must be tackled through collaborative efforts of Islamic banking and finance stakeholders such as the regulator, Islamic banks' management and public in general. The finding of the study is expected to help Bank Negara Malaysia (BNM) as the regulator to set up rules and regulation to ease the implementation of MM home financing by Islamic banks in Malaysia. In addition, this finding of this study should also draw the attention of Islamic banks' management in Malaysia to set up internal policies to tackle the challenges in the implementation of MM home financing. This study also can help the public in Malaysia in understanding MM home financing better.

The next section of this section comes out with some recommendation in order to tackle the identified challenges.

5.2 Recommendations

Based on the finding of the study, there are several recommendations made by this study in order to tackle the identified challenges. The recommendations are as follows:

- The interests of a customer could be further secured by carrying out the correct Shariah guidelines and stressing on the portion of profit and loss sharing contracts in order to clarify the misunderstanding and increase the clients' awareness.
- It is also the liability of Islamic bank's marketing division to highlight the inherent benefits and advantages associated with MM product such as the outstanding balance of MM home financing will never exceed the original amount of financing. On the other hand, it is possible to happen in BBA home financing.
- Current legal framework appears to be unfamiliar to equity based financing, there is a need to amend the laws to support MM home financing since equity financing is essential for the growth of Islamic finance. BNM, as a regulator must emphasize to eliminate the hurdles and make supportive policies and laws in order to remove unnecessary terms and conditions. For instance, purchase undertaking in the event of default by providing the necessary and proper parameters in order to safeguard the element of profit and loss sharing as part of the whole contract constituting MM home financing.
- Another issue that needs special attention is the ownership issue. Islamic banks should be allowed to legally co-own the house in MM home financing. In order to make it possible tax issues on sale and purchase and house ownership in MM home financing should also be addressed.
- BNM and other government offices with the assistance of Ministry of Education may also consider to make necessary policies to introduce Islamic Finance education at the grassroots level i.e. schools, colleges and universities, which will Make awareness amongst the pupils to understand Islamic Finance and its inherent benefits and in future, many of them would be able to become professional and qualified individual in the area and promote it at the bigger level.
- A benchmark to determine rental rate in MM home financing other than interest rate should be introduced to avoid Islamic banks using interest rate as the rental rate which creates misunderstanding in the public.
- Clear guidelines on the default of MM home financing should be established taking into consideration the uniqueness of the equity based contract since the current recovery methods



used by Islamic banks are more suitable for conventional loans or debt based contracts.

- The study also comes out with some recommendations for further studies. Further studies can complement this study by conducting a survey on or interview with Islamic banks' management in Malaysia and Islamic banks' clients on the challenges faced by them in implementing or choosing MM financing as their preferred Islamic mortgage contract. A comparative study between MM home financing and other Islamic mortgages such as Ijarah Muntahia Bittamleek (Lease that ends with ownership) should be done to find the best Islamic mortgage contract. A comparative study between the practice of MM home financing in Malaysia and other countries should also be done in order to find the best practice of MM home financing.

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