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A CRITICAL REVIEW OF COMMERCIAL PROPERTY FINANCING: THE POTENTIAL OF ISLAMIC FINANCING

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ABSTRACT

The construction sector in Malaysia grew at 8.1% from 2013 to 2016 supported by the growth in commercial property and the residential sectors at 12.5% and 9.8% respectively and has been on an increasing trend since the last four years (2013: 10.9%, 2014: 11.6%, 2015: 12.1 %, 2016: 10.3%) (Department of Statistics Malaysia, 2016). The Knight and Frank survey 2015 reported that commercial property financing comprised of 60% of properties priced at more than RM2 million and another 40% for properties priced below RM2 million. Commercial property prices have been on an increasing trend due to increased cost and interest rates as well as uncertain economic fundamentals. For Malaysia, interest rates (BLR) differ across banks ranging from 6.6% to 6.9% and the base rate (BR) ranges from 3.0% to 4.1% due to economic bubbles. Commercial property financing remains a vital issue for borrowers of both conventional and Islamic banks. For borrowers of conventional banks, an increase in interest rates means higher monthly installments which in turns may increase the default risk particularly in times of economic uncertainties. For borrowers of Islamic banks, although the financing is interest-free, the pricing of commercial property financing is still benchmarked against the conventional interest rates. This study highlights the problems that arise when

Islamic financing still relies on the interest rates. In macroeconomic theory, financing strongly depends on the movement of the interest rates. In contrast, Islam prohibits interest due to the existence of price manipulations by some parties, considered as unfair, and the lack of risk- sharing mechanism. Therefore, this study seeks to gather opinions from Islamic scholars on the acceptability of using interest rates in determining commercial property rentals as well as identifying a potential Islamic financing model where the features of the potential Islamic financing model are discussed.

Keywords: Islamic financing, commercial property, interest rate, *ijarah* rate

INTRODUCTION

The commercial property sector in Malaysia has grown rapidly in recent years in tandem with Malaysia's vision to achieve a developed country status in 2020. Similar to other sectors, financing is vital in this sector. Commercial property financing refers to the financing provided by financial institutions to corporations, business entities and investors to finance the purchases of commercial properties. There have been a number of studies highlighting the issues of relying on the interest rates in Islamic and conventional bank financing. However, there have been little attempts at providing a more stable financing mechanism which fully complies with *shari'ah.* This provides the motivation for the present study.

Malaysia is practicing a dual banking system where Islamic financing operates side by side with conventional financing where interest rate risk exists. The issue of Islamic financing mimicking its conventional counterpart has been widely debated among the Muslim society. The issues of *shari'ah*-based and *shari'ah*-compliant financing have been vigorously debated by both practitioners and Islamic scholars. Therefore, this study seeks to enrich the body of literature on Islamic finance by discussing various arguments on this issue and presenting several propositions that are relevant to the current unresolved issues of interest-based and interest-free financing, and finally suggesting several course of actions for monetary policy.

The next section of this paper will discuss the following sub-topics:

interest rate- based financing; Islamic financing; *ijarah; ijarah ala manfaah*; comparing operational definitions and formulae of *ijarah* rate, interest rate, and rental rate. Finally, the last section provides the conclusion and recommendation for future research.

INTEREST RATE-BASED FINANCING

The issue of interest began just a few years before the revelation of Islam. People in Mecca wanted to rebuild the Ka'abah after it was damaged in AD 605. They wanted to make sure that the money used to rebuild the Kaa'bah is clean and pure. Consequently, contributions from prostitutes and usurious money lenders were not accepted (Iqbal and Mirakhor, 2011). In the modern economy, the theory of interest originated from Adam Smith as discussed in Keynes (1973).

Residential, office, shopping complex and industry property financing rely on the interest rates such as the London Interbank Offered Rate (LIBOR), Kuala Lumpur Interbank Offered Rate (KLIBOR), Overnight Policy Rate (OPR), and the Based Lending Rate (BLR) imposed by Bank Negara Malaysia. Interest rate comes from the term interest. Table 3 (see Appendix) highlights the conceptual differences between interest and interest rate.

According to Abu Saud (1991), interest is the "extra money paid by the borrower to the lender, more than the amount borrowed, for the agreed delayed time". The interest rate is synonym with the debt transaction in banks or any financial institutions. The interest rate theory is the most unclear economic theory (Muhammad Uzair, 1991). This is because economists cannot justify clearly why interest rate functions like a wage. Keynes (1973) defined interest rate for money as the "percentage of the additional amount for a future contract from the spot price". Gibson et al. (2000) stated that interest rate is sometimes referred to as the cost of capital. Earlier, Fisher (1930) defined interest rate as "the price of money". He added "the rate of interest at any time, being the reward for parting with the liquidity" and concluded that "it is the "price" which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash". According to Mahmud Abu Saud (1991), Keynes believed that interest rate is the floating rate and does not rely on any reliable value.

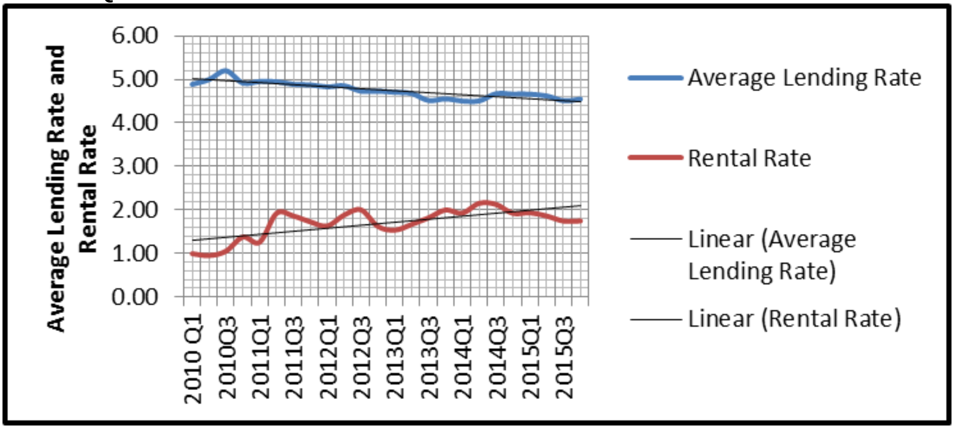
Studies on the effect of interest rate on Islamic and conventional bank financing or lending is summarized in Table 2 (see Appendix). Asbeig and Kassim (2015) found there is no significant impact of interest on bank loans. Aggarwal and Yousef (2000) also found that Islamic bank financing does not face the same issue as the interest rates but they highlighted that the fixed-payment method applied in Islamic banking is similar as debt in conventional banking. On the other hands, Yusof and Usman (2015) found that interest rate is not related to Islamic home financing at least in the short run.

In contrast, there are several studies that show that the interest rate is positively and significantly related to bank loans (e.g. Bernanke & Blinder, 1992), Islamic bank financing (e.g. Samad, 2004; Said & Ismail, 2008), and Islamic banks rates of return (e.g. Bacha, 2004; Abdul Kader & Leong, 2009). From the findings by Bacha (2004) and Abdul Kader and Leong (2009), customers prefer to go to Islamic banks during the period of rising interest rates and vice versa because customers are profit motivated. Their results are in line with Chong and Goh (2005) who found that there is a link between interest rates and the Asian Financial Crisis for both the Islamic and conventional banks in the long run. From the literature, 3-months KLIBOR is concluded as the most influential variable compared to the BLR. In addition, the disadvantages of relying on the interest rate have been extensively studied. Table 3 (see Appendix) highlights the disadvantages of relying on the interest rate as shown by several studies.

Based on Table 6 (see Appendix), past studies show that rental rate could be an alternative measure of interest rate. Therefore, the implementation of an Islamic rental rate in the commercial property sector should be investigated further due to its significant reliance on the interest rate. However, the derivatives as proposed by Purnanandam (2007) consist of *gharar*. The element of interest rate is prohibited in Islam due to the existence of *gharar (uncertainty)* element. In our study, *gharar* refers to uncertainty in the value of rental. *Gharar* appears in conventional pricing when the interest rates are formulated based on the expected return or growth of capital.

In order to strengthen the conceptual comparison between the use of interest rates as discussed earlier, a comparison between the Islamic rental value (*ijarah* rate) which is measured by the Purpose Built Office- Rental Index (PBO-RI)/ commercial property price and the interest rate (BLR) is shown in Figure 1.

Figure 1: Comparison of Average Lending Rate and Islamic Rental Rate for commercial property financing in Malaysia from 2010: Q1 to 2015: Q3

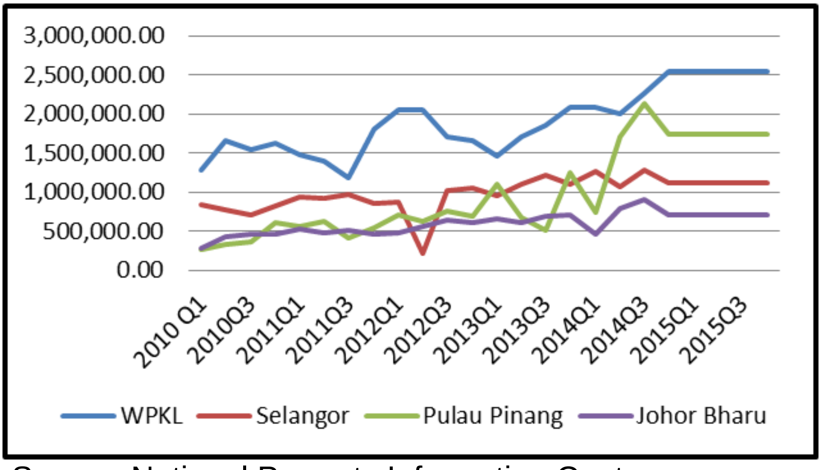


Source: National Property Information Center and International Financial Statistics

Figure 1 shows the comparison of interest rate (Average Lending Rate) and Islamic Rental Rate (*Ijarah* rate) from 2010: Q1 to 2015: Q3. Average Lending Rate is used as a proxy of interest rate following the study by Adebola, Wan Yusoff, and Dahalan (2011) and also due to the fact that Islamic banking data from 2009 onwards refer to this rate.

Interest rate shows a decreasing trend. In contrast, the Islamic rental rate shows an increasing trend. Surprisingly, the Islamic rental rate shows more fluctuations compared to the Average lending rate. The reason behind the fluctuations is changes in commercial property prices give an impact to the Islamic rental rate. The changes in commercial property prices for 4 selected states in Malaysia are shown in Figure 2.

Figure 2: Commercial property prices for Wilayah Persekutuan Kuala Lumpur (WPKL), Selangor, Pulau Pinang and Johor Bharu from 2010 to 2015



Source: National Property Information Center

Figure 2 shows the commercial property price movements in 2010 until 2015 for four selected states in Malaysia. These four states have the largest commercial property sectors in Malaysia (NAPIC, 2015). Overall, the commercial property price movements show an increasing trend. For example, in 2010: Q3, a decline in property price from RM841 million in 2010: Q1 to RM704 million in 2010: Q3 in Selangor leads to a change in the Islamic rental rates from 1.00 to 1.05, an increase of 5 basis point whereas the interest rates change from 4.89 to 5.20, an increase of 31 basis point. Therefore, we conclude that the change in interest rates seems not to depend on the price movement. Hence, *gharar* may exist. Therefore, a more extensive analysis should be taken. A review of past literature and potential Islamic financing concepts are discussed in more detail in Section 3.0 and 4.1 respectively.

LITERATURE REVIEW

The demand for financing is increasing where 60% of financing come from commercial properties valued at more than RM2 million while another 17.2% come from commercial properties below RM2 million (Bank Negara Malaysia, 2015). Interest-based financing remains an unresolved issue and are continuously being debated by Islamic scholars. Interest-based financing refers to the financing that relies on the movement of the interest rate in determining the amount of financing. Currently, LIBOR is used as an interest rate benchmark in the property sector. Bariviera, Guercio, Martinez and Rosso (2015) found abnormal behavior in LIBOR especially during the previous financial crisis that they claimed could be consistent with data manipulation. Several newspaper articles also began to question LIBOR's integrity because several global banks were submitting unjustifiably low borrowing costs for the calculation of LIBOR.

Kassim and Majid (2009) employed the Generalized Impulse-Response Functions (IRF) to test for the effect of interest rate shock on bank balance sheet. They found that in the pre-crisis (the period before 1997/1998 financial crisis) insignificant relationship exists between the overnight rate (ONR) and bank loans and vice versa. Similar results were found during the period of post-crisis. This indicates that interest rate shock did not occur before and after the financial crisis. Asbeig and Kassim (2015) continued their research by using balanced panel data approach applied on data covering the period from 2000 to 2011. They obtained similar results where changes in the base lending rate (BLR) have no significant impact on the level of financing extended by the Islamic and conventional banks. This contradicts the finding by Hakan and Gulumser (2011) who found that Islamic banks in Turkey were influenced by interest rates.

Mohd Yusoff, Alias, and Abdul Rahman (2001) studied the impact of interest on Islamic bank financing and conventional lending. Using Granger Causality test, they found that the growth of overnight Kuala Lumpur interbank Offered Rate (KLIBOR) causes significant changes in the growth of Islamic and conventional loans of the merchant banks. Similarly, the results of the regression analysis confirmed that both the Islamic and conventional loan growths of the merchant banks were positively and significantly related to overnight KLIBOR. Kassim, Shabri, Majid, and Yusof (2009) examined the sensitivity of Islamic and conventional banks to the movement of interest rate. Using Vector Autoregression (VAR) approach on data from January 1999 until December 2006, they found that Islamic banks were sensitive to changes in the interest rates whereas the conventional banks were not.

The study by How, Abdul Karim, and Verhoeven (2005) also found significantly higher interest rate risk for commercial banks with Islamic financing compared with banks without Islamic financing. Abdul Kader and Leong (2009) and Rosly (1999) studied the impact of interest rates on customers' choice in a dual banking system. In the period of 1996-1997, Rosly (1999) found there was a negative trend for Islamic banks where profits of Islamic banks decrease when interest rate increases but conventional banks showed a positive trend which was caused by the shifting behavior of customers during the financial crisis. Meanwhile, Abdul Kader and Leong (2009) found when interest rates (BLR) increase, customers will turn to financing from Islamic banks and vice versa. These show clear evidence that interest rates is an important factor influencing customers' choice of financing. Kayed and Hassan (2007) noted that global financial crises occur due to the lack of attention on banks' lending practices. Hence, a new financing mechanism should be introduced to reduce the interest rate risk faced by Islamic and commercial banks.

Previous literature shows that among the other factors contributing to financing issues are asymmetric information and adverse selection problems. In financial institutions especially bank operations in Malaysia, the main problem is that the *shari'a* principles is not fully observed and *riba*, *gharar,* and *maysir* transactions still exist (Ros Aniza & Abdul Rahman, 1997). To the best of the authors' knowledge, there is a gap in the literature on enhancing Islamic financing as there is no benchmark that links commercial property financing with *ijarah* rate, especially in Malaysia. So far, the National Property Information Centre (NAPIC) has come out with the Malaysian House Price Index, and Purpose Built Office- Rental Index (PBO-RI). These indexes are a the rental index for the residential and commercial properties, respectively (Ahmad, Daud, & Esha, 2014).

Research on the determinants of commercial property financing began in the 2000s. The determinant focused on in this paper is the interest rate. Interest rate is found to be a significant variable even though the permissibility of relying on it is still argued by Islamic scholars. Yusof et al. (2015) compared the Islamic rental rate with the interest rate. Interestingly, they found that the Islamic rental rate is not significantly influenced by macroeconomic variables in the long run. This shows the feasibility of relying on the Islamic rental rate especially in property financing. However, banks sometimes used floating rates in which the interest rate values fluctuate and change based on the changes in KLIBOR, OPR, and LIBOR. Thus, this involves *gharar* and contradicts with Islamic teachings that *gharar* must be avoided. Therefore, this study is important in promoting a fixed, unmanipulated and *shariah*-based rate namely the *ijarah* rate. Table 1 (see Appendix) shows the relationship between interest rate with the rental value, price as well as the rental deposit. Previous literature suggests that an inconsistent relationship exists between interest rate and the financing of a commercial property. The table documents the various types of relationship based on existing studies on commercial property financing.

Islamic Financing Model

The theory of rental has already existed in the age of Prophet Muhammad S.A.W. 1400 years ago. Based on Al-Imam Al-Bukhary (1993), Ibnu Thawus from Ibnu Abbas said, "Prophet Muhammad S.A.W. get cupping therapy and give the wage in the form of one or two bushels of dates" (Sahih, No. 2185).

Later, the Keynesian theory of rental based on the capitalist perspective was widely used in the 19th century until now. The Keynesian theory of rental divides rental into a dual system; social rental system and conventional rental system for residential property financing. However, this theory has been challenged by Choudhury (2006). He argued based on several sources of knowledge such as from the *Al-Quran*, *As-sunnah*, *ijma'*, and *qiyas.* Choudhury's (2006) argument is parallel with Abdullah (2002) who stated that the philosophy of knowledge must begin by the root of knowledge and the reliability of the researchers, especially those delivering the theory. Thus, Choudhury (2006) showed that the unity of knowledge means that only Islamic financing could be referred to. Moreover, instead of using the rental rate, the theory of *ijarah*[1] is used as a guideline for

[1] Ijarah is defined as "a contract whereby usufruct rights to an asset are transferred by the owner, known as the lessor, to another person, known as the lessee, at an

the rental issues.

Ijarah must be in line with the *shari'ah* concept of *ihsan (beneficence)* and *adl (justice)*. The concept of *ihsan (beneficence)* is the highest level of ibadat (worship) that is listed as one of the three important elements in Islam, namely Islam (*deen*), *iman (faith)* and *ihsan (beneficence). Ijarah* is synonym with Islamic finance where this contract has been chosen widely to replace the other types of contracts such as *Bay' Bithaman Ajil* (BBA) in residential property contracts and *murabahah* contracts in *sukuk* (Islamic bond). In this study, we highlight the importance of relying on the *ijarah* rate rather than the conventional rental rate which is not much different from the interest rate. Rosly (2007) raised the issue of injustice in using the BBA due to the fact that interest is prohibited. The prohibition of interest is clearly mentioned in the Quran:

"Trade (al-bay") is like usury (*riba*)" and Allah detailed it by saying that "Allah hath permitted trade and forbidden *riba*" (Al-Baqarah: 275). The characteristics of *riba* are mentioned in the Quran. "*O ye who believe, devour not in usury doubled and multiplied*..." (Al-Imran: 130). Based on this verse, it means *riba* occurs whenever we redouble the loan over time (Rosly, 2007). He added that the current practice of BBA home financing involves unfair profit-taking techniques since the profit earned is without mutual risk-taking. But, al-bay" is risk-taking because it relies on the Islamic ethical principles, namely "*adl (justice)*, *taqwa (fear of Allah)*, *ta'wun (mutual assistance)*, *and ukhuwwah (solidarity)*". In contrast, profit from a loan (i.e., *riba*) is created risk-free. He stated that BBA home financing practices in Malaysia involved a sale of debt. This contract is actually *bay' al-dayn*. In the context of Islamic rental pricing, the BBA home financing is better replaced by *Musharakah Mutanaqisah* (diminishing *musharakah*) and *ijarah*.

According to Omar et al. (2010), Sheikh Taqi Usmani opined that it is permissible to rely on the interest rate to benchmark the price of an asset. He gave an analogy of two sellers. Seller A sells alcoholic beverage at the cost of RM10; seller B sells mineral water at the

agreed-upon price, called the rent and for an agreed-upon period of time called the term of the lease" (Kettel, 2011).

same rate, RM10. However, the four Islamic schools of thoughts, namely Maliki, Hanbali, Hanafi, and Shafi'e have different opinions regarding the permissibility of relying on the interest rate as a benchmark as it is prohibited in Islam. In addition, Abdul Rahman (1944) stated that if the word interest is replaced with rent or profit, it implies the "renting of money". This indicates a *riba*-based transaction. Therefore, the latest studies (e.g. Askari et al., 2009; Meera and Abdul Razak, 2005; Mohd Yusof et al., 2015) have promoted the Islamic rental rate to replace interest rate in property rental. These studies agreed that the rental rate should be derived from the real sector and using interest rate such as LIBOR as a benchmark violates the foundation of the Islamic financial system.

The Concept of Ijarah

Al-Ijarah comes from the root word "*al-ajr*" which means rent or wage (Al- Khin et al., 2005; Muhammad As-Sayyid Sabiq, 2009). According to the Islamic law, rent is a contract to possess "*manfaah*" (benefit or usufruct) with payment. Currency (gold and silver), foods to consume as well as cows, camels, and goats for their milk cannot be rented. Rent is only valid for the *manfaah*, not for the goods (Muhammad As-Sayyid Sabiq, 2009). Examples of *manfaah* are renting a house or office, or renting a car. Sometimes *maanfaah* refers to wage, the payment made for the services provided by doctors, tailors, and contractors.

Ijarah is defined as "a contract whereby usufruct rights to an asset are transferred by the owner, known as the lessor, to another person, known as the lessee, at an agreed-upon price, called the rent and for an agreed-upon period of time called the term of the lease" (Kettel, 2011). Awareness of converting into the Islamic mode of financing by implementing *ijarah* concept has been proposed by Meera and Abdul Razak (2005) when they compared the application of BBA (*Bay' Bithaman Ajil*) and *Musharakah Mutanaqisah (diminishing partnership)* in property financing in Malaysia.

According to Maulana Taqi Usmani (2006), *ijarah* is divided into two types; *ijarah* on wages (operational lease) and *ijarah* on usufruct of property (financial lease). *Ijarah* on usufruct of property means "to transfer the usufruct of a particular property to another person in exchange of a rent claim from him".

Opinions from the four Islamic schools of thought; Shafi'e, Maliki, Hanbali, and Hanafi concluded that the most important element in *ijarah* is *manfaah* (usufruct) (Abdul Ghafar and Ab Ghani, 2006). Figure 3 (See Appendix) illustrates the *ijarah* mode of financing by Islamic banks.

Ijarah Rate

The term rental rate seems to be used interchangeably with interest rate as shown by studies in the UK and the US that use rental rate even when they are referring to the interest rate. For instance, the research by Tse and Webb (2003) used rental rate even when they actually refer to the interest rate.

In contrast to the interest rate, *ijarah* rate is based on the value of the usufruct (*manfaah*). According to Kettel (2011), usufruct is "the right of enjoying a thing, the property of which is vested in another, and to draw from the same all the profit, utility, and advantage that it may produce, provided it be without altering the substance of the thing". This emphasis can be seen in the study by Meera and Razak (2005) on the housing market.

Islam prohibits contracts that involve manipulations where interest rates are charged and becomes a burden to one party. Various solutions to the interest-based financing have been proposed by recent studies. For example, Saba and Alsayyed (2010) attempted to provide an *ijarah* model for Islamic home financing in Pakistan. They recommended that interest rate be replaced by a hedonic pricing model (microeconomic variables). However, there is still a lack of studies emphasizing on *ijarah* rate.

Therefore, a discussion on the *ijarah* rate is provided support the adoption of the *ijarah* rate as opposed to the current practice of interest rate benchmarking. In this study, the *ijarah* rate is defined as the rate of financing over the market price of the property. *Ijarah* rate relies on the value and the physical attributes of the property and thus is not susceptible to speculations and manipulations. The next section will detail out the comparison between the interest rate, rental rate, and *ijarah* rate.

Ijarah rate differs from interest rate where the *ijarah* rate reflects the rental of usufruct of the property and the rate charged basically reflects the asset value. In contrast, interest rate is a charge on the rental of the property, and usually assumes the "rent of money". This means money is treated as something that is valuable and the rate can always be manipulated according to economic conditions.

Table 1: Interest rate, rental rate and ijarah rate compared

	Interest rate	Rental rate	Ijarah rate
Formula	$PV = \frac{PMT}{i}\left[1 - \frac{1}{(1+i)^n}\right]$ $PMT = \frac{i(1+i)PV}{(1+i)^n - 1}$ PMT : Monthly payment PV : Bank's financing to customer i : Monthly or periodic interest rate n : Period of financing (month)	Rental rate is Rental Price Index/House Price Index $RR = \frac{RPI}{HPI}$	Ijarah rate is Purpose-Built Office- Rental Index/ Commercial Property Price Index $IJR = \frac{PBO - RI}{CPPI}$
Assets	-Artificial wealth - Only refers to underlying assets.	Any object may be the object of lease.	Certain assets are prohibited to be leased depending on certain situations.
Interest issues	-compounding based on the period of financing -not in accordance with *shari'ah*	-does not rely on interest but always have interest provision such as:	-totally free from interest by eliminating all those provisions or meet the *shari'ah* standard.

		late fees and penalty, certain types of contract extensions and interim rents	
Contractual structure	All in one agreement	All in one agreement (sale and leaseback agreement in the same agreement)	Separate contract must have separate agreement i.e.: (i)Lease (ii) Sale
Responsibility of lessors	-borrower and lender relationship	-lessors are not responsible for the maintenance of the property (only for financial lease)	-lessors are fully responsible for the maintenance of the usufruct of the property (financial +operational lease)

Table 1 shows the differences among interest rate, rental rate, and *ijarah* rate. Interest rates are prohibited due to manipulations and uncertainties. This can be seen by the charging of compound interest by banks. Compound interest is the process of interest being reinvested to earn additional interest. In contrast, rental rate and *ijarah* rate are more reliable even though the two rates are not completely similar. Detailed discussion on the differences between the concepts of *shariah*-based and *shariah*-compliant is presented in following section. There are several differences between Islamic and conventional financings as shown in Table 2. Fahim Khan (1991)

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argued that Islamic mode of financing should not use fixed rate of payment if it would like to consider the time value of money in order to cover the uncertain future risk but should use profit sharing mechanism or asset-based transaction.

Table 2: Comparison between *Ijarah* and conventional leasing

	Ijarah (Islamic rental)	Conventional lease (Rental)
Interest issues	Designed to either eliminate all interest provision elements or change it to fulfill *shari'ah* standards.	Often add interest provisions such as penalty on late payment, certain types of contract extensions, and interim rents.
Assets	Except for assets that are prohibited due to the asset itself or the use of the asset. e.g.: lease of property for the production of alcoholic beverages is prohibited.	Any asset may be the object of the lease.
Contractual structure	Contain many "curtain" arrangements. Do not put all contracts in one agreement.	Contain many "agreements" in the same contract. e.g.: sale/leaseback agreement, provision of leased asset by the lessor, lease terms, and the term of eventual resale back to the lessee after the lease period is over.
Ownership	The lessor is fully responsible for the leased assets (ownership of asset).	The lessor only acts as financier and is not responsible for any damage to the assets. (shift the burden of

		ownership from lessor to the lessee)
Late payment	No interest charged	Interest will be charged

Source: Extracted from Hossein Askari et al. (2009), Johnson (2016) and Kettel (2011).

Table 2 shows the three main differences between Islamic and conventional financing. First, from the conventional perspective, the loan given to tenants is charged interest. In contrast, Islamic financing applies *ijarah* contract and thus does not depend on the interest rate. Secondly, in conventional financing, the ownership of the property belongs to the tenant. But in Islam, the property remains under the ownership of the landlord (banks). Thirdly, in the case of late payment by tenants, a penalty or interest will be charged by conventional financing but no penalty is charged in Islamic financing.

A Model of Islamic Rental Pricing for Commercial Property Financing

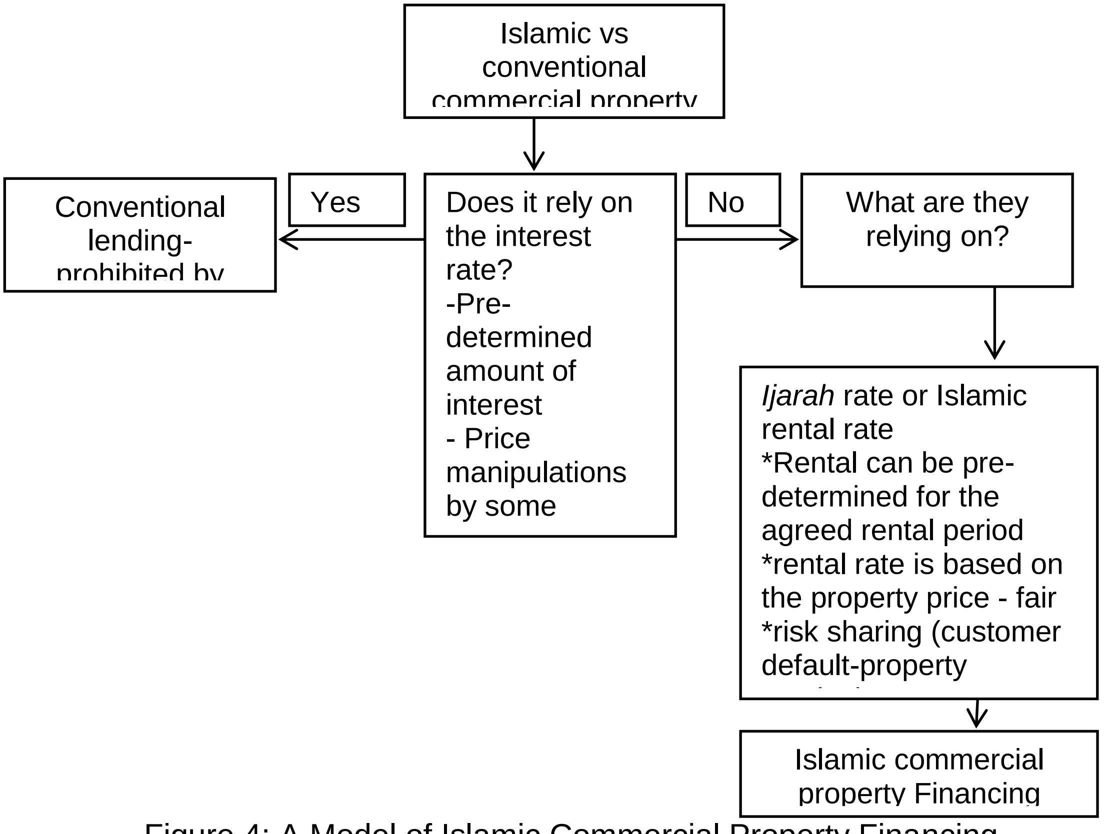

Figure 4: A Model of Islamic Commercial Property Financing

The flow of commercial property financing begins with the customers deciding whether the banks use interest rate or not in their financing. Interest-rate, as defined earlier in the previous section, comprises elements such as a predetermined amount of interest, lack of risk sharing, and is unfair because one party benefits at the expense of the other party. In contrast, if it involves the value of the property as well as the usufruct of the property, has a risk- sharing mechanism, then it is considered an Islamic commercial property financing. Among the characteristics emphasized in Islamic financing are rental is usufruct-based, relies on the price of the property which cannot be manipulated, and risks are shared. Comparison between *shari'ah*-based and *shari'ah* compliant rental are discussed in the next section.

Comparison between *Shari'ah*-based and S*hari'ah* Compliant

The use of the terms *shari'ah*-compliant and *shari'ah*-based has been debated among scholars. According to Engku Ali (2013), *shari'ah* based and *shari'ah*-compliant should not be a part of argument because both are following the *shari'ah* rulings. However, Mitchell, Rafi, Severe, and Kappen (2014) emphasized on the importance of *shari'ah* compliant financing which uses various types of contract such as *ijarah, takaful* and *musharakah* in financing.

However, Obaidullah (2005) in his book " Islamic Financial Services" highlighted that *shari'ah*-compliant is widely used in form only but not in spirit. *Shari'ah*-compliant financing includes the liabilities or sources of a fund (Obaidullah, 2005) and must have added value to the real economy (Tajudin, 2010). Rosly (1999) added that the *bay' al inah* and *tawarruq* concepts are not considered as totally *shari'ah* compliant products. This is due to the "*ilah*" of gaining profit or interest hiding in the contract or there exist uncertainty in the contracts. He proposed that Islamic debt financings use the *mudarabah* contract where the risk sharing mechanisms exist and interest elements could be eliminated even though the income received by stakeholders is a pre-determined fixed income. Obaidullah (2005) highlighted that the *ijarah* contract used in Islamic financing is the rental of the usufruct (*manfaah* of the assets) as income is generated and divided according to the rate agreed by the contracting parties. These contracts use certificates of debt known as "*sukuk*" which are fully negotiable and are easily sold and bought via the secondary market. The price of the *sukuk* is determined by the profitability of the funds.

The current challenges of Islamic financing are that it "mimics" conventional financing where some elements are modified so that the financing complies to the "*shari'ah*" (Tajudin, 2010). Tajudin (2010) emphasized on the need for having a quality and sophisticated instrument in financing that can meet the increasing demand for financing but always comply with the *shari'ah* rulings, is cost effective, has competitive price and is reliable. The Shari'ah Advisory Council (SAC) defined *shari'ah* compliant as complying with the standard of "*umum-balwa*" which means prohibited elements affecting people's life that are difficult to avoid where the benchmark used is the mixed product is considered acceptable if it contains up to 25% of prohibited elements.

The fully *shari'ah* compliant benchmark still needs to be further enhanced to remove hardship among Muslims (Zainudin, Miskam, & Sulaiman, 2014). Therefore, the latest screening methodology of *ijarah* contract concludes that the rental income from non-*shari'ah* assets should not be more than 20% of total income. However, Adam and Bakar (2014) argued that *shari'ah* compliant should not only be limited to the percentage of stock screening methodology as announced by SC but to fully comply to *shari'ah* all the time. (Schoon, 2007) stated that full-fledged Islamic banks are considered as *shari'ah* based, in contrast, Islamic window represents *shari'ah* compliant financing. The reasons behind his argument are *shari'ah* compliant financing needs to satisfy, at a minimum, the criteria of *Shari'ah* law regarding the avoidance of *Riba, Maysir*, and *Gharar*. Once these are satisfied and the bank obtains *Shari'ah* supervisory board approval, the product or structure can be marketed as being *Shari'ah* compliant product. On the other hands, *shari'ah* based means that not only do individual products have to meet all the requirements, but all operations within the bank are required to be compliant with *Shari'ah*. Thus, large conventional banks have more advantage in the balance sheet over the potential Islamic financing (Schoon, 2007).

CONCLUSION AND RECOMMENDATION

This study highlights the potential of Islamic financing specifically in the commercial property sector in Malaysia. The potential Islamic financing model suggests adhering to the Islamic rental rate, in this case, known as the *ijarah* rate, due to it being compliant with Islamic concepts. However, further empirical studies should be carried out to test for the stability and reliability of this rental rate as compared to the interest rate which is influenced by manipulations and speculations, and has adversely affected the reputation of Islamic banks. The novelty of this study comes from the proposal to adopt the *ijarah* concept into the current rental rate which emphasized the Islamic concept. The *ijarah* concept integrated with the *ihsan* *(beneficence)* and *'adl (justice)* concepts will assist banks specifically in promoting viable rental rate to replace the conventional interest rate in the financing of commercial properties.

As for recommendations for future research, analysis on the application of *ijarah* rate in the real world could be undertaken as well as looking into the perspectives of landlords and tenants towards its application. With regards to government policy, this paper recommends that the government intervenes in the property market so that the manipulations of price and rental rate can be contained. For the banks, this paper hopes that the *ijarah* rate could replace interest rate in commercial property financing. We also suggest that the potential Islamic commercial property financing should become a major focus of research by academicians and Islamic economics' scholars to enhance the Malaysian economy in the future.

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APPENDIX

Table 3: Differences between interest and interest rates

	Definition	
Author(s)	Interest	Interest rates
Mahmud Abu Saud (1991)	"extra money paid by borrower to the lender, more than the amount borrowed, for the agreed delayed time"	"interest rate is the floating rate not relying on any reliable value".
Keynes (1973)	NA	a "percentage of the additional amount for a future contract from the spot price".
Gibson et al. (2000)	NA	"interest rate is sometimes called as the cost of capital".
Fisher (1930)	"Interest is computed by multiplying capital value with the rate of interest"	interest rate is defined as "the price of money".
(Mishkin & Eakins, 2009)	NA	The interest rate is the interest payment divided by the loan principal; the percentage of principal that must be paid as interest to the lender.
(Kellison, 2005)	"Compensation that a borrower of capital pays to a lender of capital for its use" "Interest can be viewed as a form of rent that the borrower pays to the lender to compensate for the loss of use of the capital by the lender while it is loaned to the borrower."	NA
(Iqbal & Mirakhor, 2011)	"Riba" is the practice of charging financial interest or a premium in excess of the principal	NA

amount of a loan".

Source: Extracts from conventional and Islamic scholars' points of view.

Table 4: The relationship between interest rates and Islamic and commercial bank financing or lending

Year	Authors	Analysis	Proxy of interest rate	Types of banks	Interest rate related to Islamic banks financing (+/-)	Interest rate related to conventional lending (+/-)
1992	(Bernanke & Blinder, 1992)	VAR and bivariate VAR	The federal fund's rate (FUNDS), The 3-month treasury bill rate (BILL), 10-year treasury bond rate (BOND)	Commercial banks	NA	an interest rate on Federal funds is extremely informative about future movements of real macroeconomic variables
2000	(Aggarwal & Yousef, 2000)	Optimal efficiency	Fixed nature of the payments but not interest.	Islamic bank and commercial bank financing in Malaysia and Jordan	Islamic bank financing inclines more towards debt-like instrument.	NA
2004	(Samad, 2004)	Equality of means test	Overnight KLIBOR	commercial bank, finance company, and merchant bank	+*	+*
2004	(Bacha, 2004)	Panel (Granger-causality, Pearson correlation	3-months KLIBOR	Islamic banks in Malaysia	Changes in conventional interest rate caused the changes in	NA

		coefficient, OLS regression)			Islamic banks' rates of return.	
2005	(Chong & Goh, 2005)	VECM (Unit root test, ADF test, Johansen test, BIC, F-test) Granger-causality test	Real interest rate as a proxy of real economic activity	Malaysia	Real interest rates are linked to Asian financial crisis in the long run.(before and after AFC)	
2008	(Said & Ismail, 2008)	Panel data	Interbank rate	Islamic Banking in Malaysia	Changes in interbank rate will change the amount of financing provided by banks.	NA
2009	(Abdul Kader & Leong, 2009)	Cointegration, VAR, Granger Causality and IRF	Base lending rate (BLR)	Islamic banks in Malaysia	Increase in BLR results in more customers obtaining financing from Islamic banks and vice versa.	NA
2015	(Yusof & Usman, 2015)	ARDL bound cointegration test approach, IRF and forecast error variance decomposition.	BNM Overnight Policy Rate - Middle Rate (OPR)	Islamic home financing	Interest rate not related to the financing at least in the short run.	NA
2015	(Asbeig & Kassim, 2015)	Wald test FEI, GLS model, and OLS model.	BLR	Islamic and conventional banks in Malaysia	No significant impact	No significant impact

Source: Authors summary of previous findings.
*indicates significant

Table 5: Past studies of property market and some issues on using interest rate as a benchmark of rental rate

Year	Authors	Area	Issues/Problems Related to Interest Rate in financing
2004	Bacha (2004) and Rosly (1999)	Islamic banks	Islamic banks operating within a dual banking system may also be subject to interest rate risk.
2008	Said and Ismail (2008)	Islamic banks	Islamic interbank rate significantly shows the effect of changes in total loans.
2009	Abdul Kader and Leong (2009)	Islamic bank financing	Increase in the base lending rate would induce customers to obtain financing from Islamic banks and vice versa
2009	Kassim et al. (2009)	Conventional and Islamic bank in Malaysia	Islamic banks' balance sheet items are relatively more sensitive to monetary policy changes, while the conventional banks' balance sheet items, particularly the conventional loans are insensitive to interest rate changes.
2011	Ibrahim and Sukmana (2011)	Islamic financing in Malaysia	Found that Islamic financing in Malaysia is driven mainly by interest rate variations, is minimally affected by stock market fluctuations and not influenced real industrial production
2012	Muhammad, Sulaiman@Mohamad, Mohd Hussin, and Abdul Razak (2012)	Malaysian monetary transmission	The conventional rate is still leading indicators to the Islamic interbank money market in Malaysia at present.
2015	Hasin and Majid (2015)	Malaysian monetary transmission	Islamic banks is not spared from interest rate

Table 6: Past studies of alternative to the interest rate as benchmark of rental in financing

Year	Authors	Area	Issues/Problems Related to Interest Rate
2005	(Meera & Abdul Razak, 2005)	Home financing	Rental rate as an alternative to the current interest rates.
2007	(Purnanandam, 2007)	Banking	Derivatives is used to mitigate interest rate risk
2011	(Yusof, H. Kassim, A. Majid, & Hamid, 2011)	Home financing	Consistent evidence that the rental price (RP) is a better alternative than the lending rate (LR) to price Islamic home financing product.
2015	(Yusof & Usman, 2015)	Home financing	They propose rental rate as an alternative measure.

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Table 7: Definition of *Ijarah*

School of thought	*Ijarah*
Maliki	"a contract which relates to permissible usufructs for a particular period and a particular consideration not arising from usufruct" "*Ijara*" contract to the human usufruct and the moveable objects other than vessels and animals. They call the contract on usufructs of land, houses, vessels, and animals the term "*Kiraa*", so they said *Ijarah* and *Kiraa* have the same meaning.
Hanbali	A contract for a particular permissible usufruct which is taken gradually for a particular period and a particular consideration
Hanafi	A contract which enables possession of a particularly intended usufruct of the leased asset (*Ayn*) for a consideration.
Shafie	A contract for a defined intended usufruct liable to utilization and accessibility for a particular recompense

Source: Dallah Al-Baraka Group (n.d.) and Ibnu Qudamah (2010)

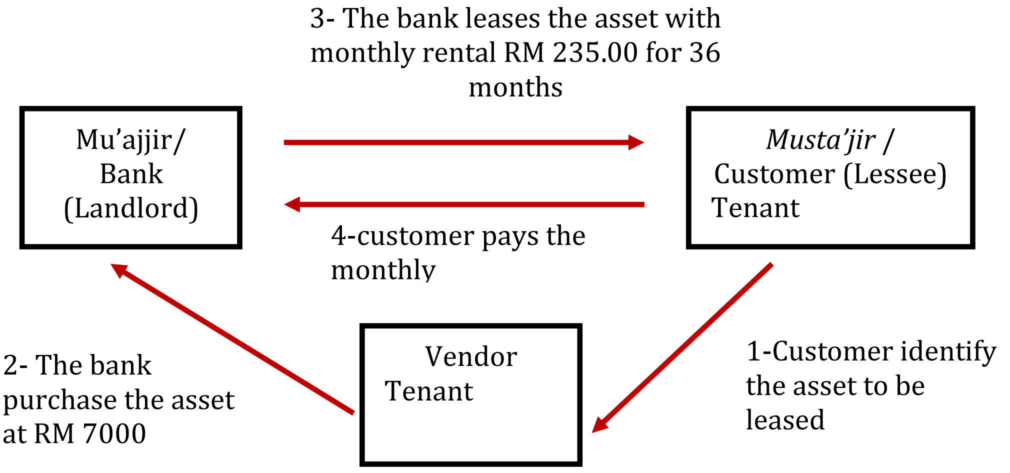

Figure 3: Ijarah mode of financing in Islamic banking.
Source: (Mohammad Khairi Saat, Razli Ramli, & Haryani Aminuddin, 2011).