

BUSINESS *and* FINANCE

Emerging Issues

Editor
Norazah Mohd Suki



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CHAPTER 6

BBA HOME FINANCING SETTING IN MALAYSIA

Mohd Zulkifli Muhammad, Minah Japang and Zakiah Hassan

Introduction

This chapter discusses two major approaches of home financing options available in Malaysian namely conventional housing payment and Bai Bithaman Ajil (BBA) financing. BBA home financing is an Islamic housing payment facility, which is based on the Syariah concept of Bai Bithaman Ajil or in short BBA. It is a unique contract of deferred payment sale on Islamic home financing.

In 1997, when the Asian Financial Crisis occurred, home financing activities seemed a bit slow as the result of higher interest rates, depressed housing prices, hike in unemployment rate and declining household incomes. Furthermore, the quality of property loan credit was more affected rather by individual mortgage loan, which tended to give external shocks as well stretch the underwriting conditions. Thus, both the legal sorority and banking industry were quite alarmed and concerned about this situation.

Nowadays most bankers and financial institutions offer a homeowner loans, a choice of either a conventional loan or Islamic financing. Should a household question the differences between these two finance techniques, the simple answer is that, both financing facilities are the same, except in a conventional loan, the purchaser will pay interest and in Islamic financing, the purchaser will pay a profit rate. According to Mike Maguid Abdelaaty, president of American Finance House – LARIBA said that the key difference between Islamic and traditional mortgage is in the rate of return.

BBA Concept of 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) (Mohd Nasir, 2007). 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 to by both parties (Khir et al, 2008). Profits in this context are justified since it is derived from the buying and selling transaction as opposed to interests accruing from the principal lent out. All the components to determine the selling price have to be fixed because the selling price have to be fixed at the time the contract is made, Hence, the profit rate for BBA financing is fixed throughout the period of financing (Saiful, 2005).

The BBA's concept is popular and widely used in Malaysia. This concept has been approved by Shariah Board, which is centred in Central Bank of Malaysia and majority of Islamic Banks in Malaysia. Until December 2005, BBA's concept was used as 52.9 per cent in the publication of Islamic Bon (Sukuk) rather than other concepts. During 2005, this concept was widely used- about 41 percent in financing customer products. This entire figure showed that this concept is comfortably used by Islamic banking in Malaysia. In fact, it is also popularly used in Brunei and Bangladesh (A. Rahman, 2006 - Head, Shariah Coordinator, Asian Finance Bank Ltd.).

Simultaneously, the bank sells the property to the customer at a selling price, which comprises the bank's purchase price and a predetermined profit margin. The agreement between the bank and the buyer of the house is called the property sale agreement. Since Islamic financing requires a predetermined profit to be made by the bank, a buyer will never have to worry about a sudden hike or change in the interest rates. From the beginning of the transaction process, the buyer will know the total amount which he/she has to pay to the bank and it was acknowledged that the monthly instalment of the bank's selling price would not change throughout the term (tenure) of the financing.

Thus, under this concept, a seller-buyer relationship will be established and the selling price is fixed upfront. The sales price is then repaid in periodic instalments and the agreed instalments will remain fixed throughout the financing period. As such, the customer's risk with the interest is eliminated. Furthermore, arrears will not be capitalised (Salahuddin, 2006). Normally for

a house or residential property financing, the maximum repayment period is 30 years or by the age of 65, whichever is earlier. It might differ from one bank to another (George, 2003). The sales purchase process will take place as shown in Table 6.1.

Table 6.1 BBA contract flow

(1)
Customer notifies the related assets to the bankers
(2)
Financial institution buys the related assets from the assets' owner
(3)
Financial institution sell backs the assets to the customer with mark up price agreed to by both parties
(4)
Customers pays sales price by monthly instalments to the financial institution

Source: Nora Yusma, M. Y., Sanep, A. and Mohd Anuar, A. I. (2007)

Characteristics of a Loan

Purchasing a house can be a valuable form of investment. However, considerable thought and careful financial planning is needed before taking on such a big step. Most people take on a housing loan from banking institutions, which offer different loan packages to cater to the needs of different users. Different financial institutions have different criteria in calculating the repayment capacity. Calculation of a loan is based on the payment of interest, the tenure of the loan and the margin of financing.

Margin of Financing

The amount of financing provided by a financial institution depends on the market value, for the completed properties only or purchase price of the house, whichever is lower. The margin of financing could go as high as 95 per cent of the value of the house. It is assessed on factors such as type of property, location of property, age of the borrower and income of the borrower.

Loan Tenure

The length of a loan can range anytime up to 30 years or until the borrower reaches the of 65 or any other age as determined by the financial institution, or whichever is earlier.

Loan Features

Each financial institution packages its housing loans differently. Therefore as a buyer, one should examine all the features of a loan package. Pricing is just one consideration but other features like repayment terms could balance the scale or even translate into greater loan savings.

However, in some cases, the close relationship between the bank and customers makes the bank willing to finance their loan. In such situations, it depends to a great extent on trust. Jimenez and Saurina (2002) studied the impact that certain characteristics of a loan (i.e. collateral, maturity, size, type of lender and closeness of customer-bank relationship) have on default rate or credit risk. They found that when a bank has a strong relationship with a particular customer or exclusive relationship, the bank is more willing to finance higher risk projects. It also showed the marginal impact of each characteristic of a credit operation on probability of default (PD), highlighting the utility that this can have for a banking supervisor interested in off-site monitoring of credit risk or in an improved allocation of scarce resources when carrying out the necessary on-site monitoring.

Previous Studies

Ever since the principles of Islamic finance were laid down in the Holy Qur'an 14 centuries ago, the development of Islamic financial institutions has undergone severe challenges. It was only during the final chapter of the 20th century that people could see the global network of Islamic banks and other financial institutions started to take shape (Abdul Halim and Norizatun, 2000).

Historically in Malaysia, back in 1983, there was only one bank that provided Islamic financial products but now almost all local and commercial banks provide Islamic financial facilities. The basic difference between Islamic and non-Islamic banks lies in the fact that the former operate on an equity

participation system in which a predetermined rate of return is not guaranteed, whereas the latter's operation is based on both equity and debt systems that are driven by interest. Therefore, the researcher tried to examine Islamic banks's strategy in educating the public about their existence and products. One of the products is Bai Bithaman Ajil (BBA) and they found that 21.5 per cent of people knew about existence of BBA, 75.2 per cent did not know about the product and 3.3 per cent had no response.

Prior to 1997, the absence of banking regulatory support meant that all US efforts to provide Islamic home finance had been ad hoc and capital-constrained. To a lesser degree, they have limited integration to either shari'ah scholarship or the international Islamic capital market.

Nevertheless, nowadays, BBA's concept is being widely used in Malaysia as this concept has been approved by Shariah Board, which is centred in Central Bank of Malaysia and is rapidly applied in major Islamic Banks in Malaysia. For instance, until December 2005, an Islamic home financing concept of BBA has been involved 52.9% in the publication of Islamic Bon (Sukuk) rather than other Islamic financial instruments. However, in terms of customer product financing, BBA concept has been given a proportion of 41%. All these figures show that this concept is comfortably used by Islamic banking in Malaysia.

On the other hand, the same concept of home financing is also widely used in Brunei and Bangladesh (Rahman, 2006) compared to the conventional loan where the customer will repay to the bank the loan amount, together with interest at the agreed rate. The rate is based on a margin above the bank's base lending rate (BLR), and normally, both the margin and the BLR are variable from time to time. In the case of late payment or default, the bank is entitled to charge compound interest. Interest payable may also be capitalised and the capitalised amount will be subject to further interest.

Saiful, Mahmood and Norhashimah (2000) in their paper argue that the application of bai-bithman ajil contract in Malaysian Islamic banks seems to overlook the requirement of 'iwad. According to them, theoretically, in a BBA sale the bank as a seller must be liable for any product defect and the ensuing compensatory damages. The option of defect (Al Khiyar al-Ayb) is operative once the goods are sold, which the bank must honour in order to

claim legitimacy on the profit made. As a conclusion, based on the given rules on Khiyar 'Ayb, it is apparent that an Islamic bank as a selling party must hold all liability arising from all defective goods sold. However, in practice, as shown in the respective legal documentations, it is evident that the bank holds no such liability. Furthermore, an Islamic bank that practices Bai-bithaman ajil seems to only champion its right without conferring duties of equivalent values to the buying party. In fact, it has transferred relatively all the risk and liabilities to the customers.

Seko (1993) presented a microeconomic model of Japanese housing demand focusing on the Japanese home financing system. The emphasis was on the tradeoffs between housing quality and quantity by analysing the user cost of capital of owner-occupied housing for several different sub samples. The unique features of the model are the nonlinear budget constraints. Besides that, this research executed reduced form estimation on the composite housing demand model and the characteristic housing demand model. The result showed that the price and income elasticity of composite housing demand are approximately -0.74 and 0.60 respectively, those of floor demand are -0.13 and 0.31 , respectively and those of quality demand are -0.67 and 0.49 , respectively. Estimation result also indicated that housing demand by non-JHLC borrowers is more price elastic and more income elastic for composite housing demand and floor demand, but JHLC borrowers are more price elastic for quality demand. The paper derived about 328,000 yen per household in 1986 for housing quantity and 38,500 yen for housing quality based on a characteristic housing demand model.

According to Thomas (2001) although a major international bank worked with both a US mortgage bank and a key Islamic bank to structure an Islamic home finance programme as early as 1993, no formal regulatory framework or authorization existed for such a programme prior to 1997. Once the Office of the Comptroller of the Currency (OCC) granted authorization and later approved, instalment sales began with bank taking title to property as a banking instrument in 1999. The rulings were based upon a series of common factors. Firstly the regulators examined the bank's request and evaluated its similarity in risk and purpose to existing banking powers and secondly the regulators reviewed whether or not the interpretation would result in making banking more inclusive. This conclusion allows regulators, vendors and investors, including banks and agencies to find it reasonable to examine the newly emergent product class.

As financial markets move toward increased globalisation, it becomes worth considering whether inherent differences in financial markets across different countries will diminish. On the other hand, Courchane and Judith (2001) examined some of the differences in policy and in competitive practices between Canada and the USA in an attempt to explain why differences in rates and terms across the two countries still exist. They found that despite similar homeownership rates, the structure of the mortgage markets, the public policy objectives, the rates, terms and products of mortgage instruments all substantially differ across the two countries. Those disparities do not appear to result from differences in the demographics affecting housing demand across the two countries. As a result, they found that many differences came from the public policy objective across the two countries. In US, the longer term loan practices led to interest rate risk being shifted to the global market with the development of mortgage securitisation. There was no such need in Canada as borrowers did not have the power to influence the government to follow the US route.

Furthermore, Canada has often used homeowner incentives schemes, rather than affecting outcomes through policies on the supply side. In addition, the factor leading to substantially different products across the two countries is likely the cause of relatively concentrated primary mortgage finance market in Canada. Meanwhile there are no particular incentives for banks to move toward any products as favourable to borrowers, as those most typically preferred in the US.

Other researchers, Davies, Gyntelberg and Chan (2007) examined the role of government supported housing finance agencies in Asia. They estimate the size of the government subsidies received by these agencies and their distribution among households, financial institutions and the agencies themselves. As a conclusion they found that in Asia, government-supported housing finance agencies have played a constructive role in the development of domestic residential mortgage and bond markets. In most countries, they have not required large government subsidies. For example in all countries except Singapore, the level of government support is below 0.1% of gross domestic product (GDP). The housing finance agencies have also managed to transfer most of the benefit of their government support to either households or financial institutions. However, in Japan, one of the reasons why the GHLC's role was refocused away from direct lending towards supporting securitisation of mortgage originated from private lenders. Here the risk was

that the government subsidised housing agencies will distort competition, crowd out private lenders and mortgage insurers, and ultimately hinder market development.

Ariccia, Igan and Laeven (2008) observed the current sub-prime mortgage crisis to a decline in lending standard associated with the rapid expansion of this market. As a result, they found that the recent rapid credit expansion in the supreme mortgage market was associated with easing credit standards and the current troubles in this market are more severe in the areas where the expansion was faster. There are three conclusions in lending standards. Firstly, the rapid credit growth episodes tend to breed lax lending behaviour. Secondly, lower standards were associated with a fast rate of house price appreciation, consistent with the notion that lenders were to some extent gambling on a housing boom, relying on the fact that borrowers in default could always liquidate the collateral and repay the loan. Thirdly, change in market structure mattered as lending standards declined more in regions where (large and aggressive) previously absent institutions entered the market.

Government and BBA Financing

Property market has experienced a tremendous high domestic demand in the early 1990's with particularly two peaks sessions – in 1991, when a 26 per cent year on year real price growth was achieved and in 1995, with 18 per cent real price growth. After the Asian Financial Crisis hit Malaysia, the average price declined during the economic slowdown. Before 1997, the price increase could be because of high demand and increased cost of construction materials and labour. Furthermore, the demand for houses was also supported by the ready access to financing. However, the price of low cost houses for the low-income group remained relatively stable because of the price control imposed by the government. Until beyond 1998, the demand for low-cost housing was still maintained because of the continuous government support to help these low-income target groups.

In response to the fierce property market competition, the government has indeed made some radical changes in the issue of housing policies. The duty of the government is to provide housing to the people and take care of their welfare. Yet, there is ample room for improvement. In the Malaysian context, there are public and private agencies which are established and are able

to help people get information and they are always available to support buyers in buying a house. They are the Ministry of Housing and Local Government, Cagamas Berhad and the National House Buyers Association.

The government indeed has made some essential changes when addressing the public housing issue. The government's role is to facilitate and provide better fundamental housing development regulations and balance the financing mechanism in order to meet the public's interest and developer's mission of providing more affordable housing.

The Prime Minister's Department, in addressing the prominent issues when it comes to buying a house, has advised buyers to first study the condition of purchasing a house. In other words the developer should complete the houses before selling them to potential buyers. The concept of 'build-and-sell' is voiced by society especially when the buyers often experience the problem of abandoned housing projects and unsatisfactory design. Most often the reasons could stem from relying on the advertisement and believing in great promotions and false promises made by the developer. The call by the PM for developers to build houses first before selling them should be lauded.

According to the Communication Director, Mohd Yusof Abdul Rahman, the application of this method will cause the price to increase by 10 to 20 per cent but it is still acceptable because the buyers will be satisfied with the quality of the houses built. He said, buying a house is a huge investment and it is usually made once in a lifetime. Nowadays, the build-and-sell concept provides advantages to the developers. The buyers will just wait and imagine their future houses with uncertainty until the houses are completed (Berita Harian, April 7, 2008). He responds to the possibility of the bank refusing to fund build-and-sell projects by saying that housing projects have high potential and return and banks should not be afraid to provide the needed financing.

Moreover, the government, he added, should play an active role if the representative banks refuse to fund the projects by:

- i. creating a housing fund to smooth/ help the housing project at an early stage as a security on the bank's side; or
- ii. giving land to developers without their purchasing the land first to build the house or in other words, the developer builds the house without prior purchase of land from the government; and

- iii. boosting and monitoring the architects and engineers who are appointed by the government instead of the developer to ensure the work done is transparent.

BBA and Conventional Loan Data

In order to compare the allocation of housing loan between BBA home financing and conventional home financing, we get through a set of home financing data from four major banks operating in Malaysia. Two banks represent major BBA home financing and another two banks represent the conventional home loans. Figure 6.1 below illustrates BBA financing between Islamic Bank 1 and a Commercial Bank 1 with the range of BBA financing data of 2000 – 2006. From the figure it is justified that when it comes to BBA financing activities, the public tended to prefer an Islamic banking procedure in carrying out the respective loans.

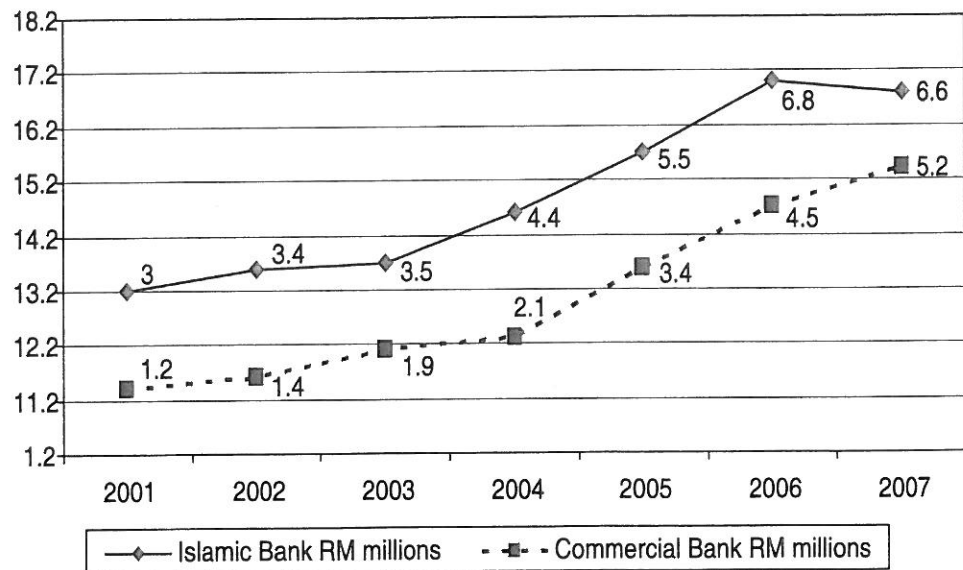


Figure 6.1 BBA financing table from Islamic bank and BBA financing of commercial banks
Source: Various banks Annual Report (2008)

Figure 6.2 however, represents the conventional loan portion of the housing financing between two major commercial banks, namely Commercial Bank 1 and Commercial Bank 2 within the range of loan allocation data of 2000 – 2006.

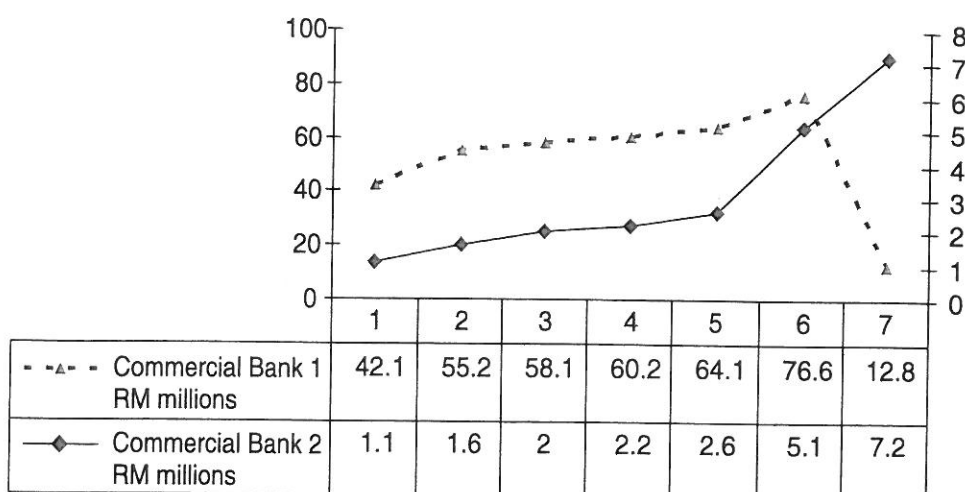


Figure 6.2 Conventional home financing value between two selective commercial banks

Source: Various Banks Annual Report (2008)

Both Figure 6.1 and Figure 6.2, show that BBA finances either in Islamic bank or commercial bank obviously indicate distinctive awareness among Malaysian public in choosing BBA housing financing offered in the market. It also shows that BBA financing is increasingly preferable among buyers as well as the conventional housing loans.

Recommendations

Recently, there were issues and debates on whether the housing industry should adopt the build-and-sell concept. The then Prime Minister Datuk Seri Abdullah Ahmad Badawi said it was not right that the house buyers had to pay before they can get their houses. His worry was that people who had paid for their houses later found their project being abandoned. He wanted developers to have adequate funds before embarking on housing projects and 'not sell first to get the money to build'. He said that consumer advocates are, of course, 100 per cent in favour of the concept because they think it could solve most, if not all of the problems that have plagued Malaysian house buyers. Such include late delivery of houses, substandard workmanship and abandoned housing schemes.

Housing developers, however, were adamant and opposed the concept because the current build-and-sell concept favoured them in every imaginable way. Nevertheless, bankers and economists warned that the adoption of the build-and-sell concept could be injurious to the interests of house buyers as it would almost certainly raise the purchase price of new houses. In actual fact, the idea of making it compulsory for developers to build houses before they sell them has been around since Tun Abdul Razak's time, but developers have always argued that the housing industry was not ready for such a major paradigm shift.

Real Estate and Housing Developers' Association (Rehda) president Datuk Jeffery Ng Tiong Lip claimed that the build-and-sell concept still needs several factors that can affect sustainable growth. The national objective of home ownership still needs to be ironed out. Firstly, there is the level of maturity that the build-and-sell concept needs to be implemented immediately. Malaysia needs between 100,000 and 150,000 new houses each year. The adopting of build-and-sell concept will result in a significant reduction in housing production and market players and this could lead to potential social and economic implications. Secondly, developers would have to seek project loans instead of bridging finance and the financial institutions would not consider lending if they could not gauge the viability of the projects.

Moreover, he said that, the banks have been known to be reluctant to lend when conditions are not risk-proof. *'Even under the present sell-and-build system where developers can demonstrate viability based on sales, banks have been known to be reluctant to lend when conditions are risky'* said Ng. He believed that build-and-sell concept is not applicable now but needs to be further explored through discussions with all relevant parties, including the Finance and Housing and Local Government ministries, banks and some industries which are directly and indirectly linked to the industries. Ng also stressed that the build-and-sell concept can improve Malaysia's economics of scale throughout building phase-by-phase units of houses through the same system, which is widely practised in Australia, the United Kingdom and the United States.

All in all, it can be concluded that:

Buyer

- The buyers should do research before they decide to buy a house.
- The buyer should survey all banks, which offer conventional and Islamic loans.
- The buyer should investigate the developer before they make a deal.
- The buyer should know their rights and obligations as buyers to such loan that they are going to take.
- When the buyer defaults in his/her instalment payment, actually the default is not from the buyer but from the institution, which handles the payment. So as a buyer, he/she must check from time to time the payment transfer is directly from their account so that the payment will not be delayed.

Developer

- The developer can choose any concept which they prefer, but they must place priority to build houses which can bring in the profits and avoid abandoning projects.
- The developer must try to protect the environment in the implementation of their respective projects.
- The developer should manage their fund well and try to utilise their budget in housing projects. They should have spare 'petty cash' in their planning management.
- The developer can build houses based on customers' satisfaction. Therefore, they can avoid losses to a minimum level.
- The developer should plan their research and development well before they decide to be involved in a housing project.
- At an early stage, the developer can build housing units in small quantities with basic community facilities such as mosque, playground and *balai raya*.
- Try to maximise the benefit they have for example a collection of 10 per cent from the price of the house to start their project as promised and at the specified date.

Bank

- House financing can create greater revenue for banks. However, the bank must give loans with minimum rate and not burden the buyer.

The rate plus Base Lending Rate (BLR) must be a minimum rate so that buyers can manage their savings well. At the same time, the bank can minimise their credit risk and reduce their non-performing loan (NPL), which can affect the bank in future trading. Besides, the bank which can manage their credit liquidity well can make another profit and use their profit to finance other projects.

- Bank can make investigations on future customers in terms of their ability to get a loan; therefore, banks can minimise the default risk of buyers. Normally, buyers with close relationship with the bank have advantages whereby the bank is willing to lend to them without apparent restriction on their application.
- When buyers default in payment, actually the default is not from the buyer but from the institution, which handles the payment. Banks, which are responsible to pay the developer, must make sure the payment will not be delayed.
- Set up a department or division specialising in all subject matter related to lenders.

Government

- Establish an act, which is friendlier for example if the home is built but could not be completed at a specified date, the buyer can collect 50 per cent from the sales price.
- The Central Bank of Malaysia (Bank Negara Malaysia) to act on behalf of the government as a lender of last resort. It can give funds and moral support to commercial banks, merchant banks and Islamic banks to finance funds.
- Make a plan and target the specified areas that can be used as a means of national development. For example, find a suitable place, which relates to the demand of the buyers of a house.
- Land is a profitable investment of real estate, which may gain higher returns in the long term. Therefore, the government could consider giving a lower price as well as an incentive to the developer to finance the project.
- They can also monitor the activities of developers from time to time until the house is completed. The government also can give ratings to high performing developers and give benefits and incentives to them as well (The Star, 13 April 2008).

Conclusion

As a conclusion, it is an essential decision to buy a house and thus, buyers should be more aware in evaluating and making firm decisions about housing financing offered in the market. It does not only concern the suitability of loan options, but the choice of the right financing tools that can provide them with maximum satisfaction in purchasing a piece of property or obtaining the related services. Thus, it is up to the buyers to make their own decision to either go for conventional financing mechanisms or apply to BBA financing approach offered by Islamic banks or other commercial banks.

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Companies necessitate to become widely recognized for their extraordinary concentration to customer service. Applications of mobile phone and other related technologies that include the internet, PDA and e-mail by consumers have provided an opportunity for them to obtain more product information freely and independently. They practise the pervasive use of complex web enabled applications. Businesses are realising that the performance and availability of their technologies are critical to their growth and competitive advantage.

Businesses through brevity spirit are required to keep abreast with the market's unstoppable and changing demands by detecting and diagnosing emerging business and finance issues in this complex and heterogeneous environment, which presents a formidable challenge. This, at the end, could reinforce the company's goals productively.

This book focuses on the examination and application of business and finance principles to the development and implementation of business strategies. Specifically, the book grants substantial deliberation to issues on business and finance. The book comprises of seven remarkable chapters. Each chapter has several diagrams and tables that explain the emerging issues.



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