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Full Length Research Paper

Islamic house financing: Comparison between *Bai' Bithamin Ajil* (BBA) and Musharakah Mutanaqisah (MM)

Nooraslinda Abdul Aris[1], Rohana Othman[1]*, Rafidah Mohd Azli[2], Roshayani Arshad[1], Mardiyyah Sahri[2] and Abdul Razak Yaakub[3]

[1]Accounting Research Institute and Faculty of Accountancy, Universiti Teknologi MARA, Shah Alam, Malaysia.
[2]Center for Islamic Thought and Understanding (CITU), Universiti Teknologi MARA, Shah Alam, Malaysia.
[3]Islamic Banking and Finance Institute, Malaysia.

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***Bai' Bithaman Ajil* (BBA) house financing concept was introduced in Malaysia by Bank Islam Malaysia Berhad (BIMB) upon its establishment in 1984. The product is an alternative to the conventional housing loan offered by most conventional banks as it is said to be *Shari'ah* compliant and free from the elements of *riba'*, *gharar* and *maisir*. Since its introduction, many views, studies and comments have been made on the concept of the product which is claimed to be unacceptable by other Muslim countries. As an alternative product to the conventional housing loan, the BBA house financing need to be enhanced and stand at par to remain competitive. Over the years, controversial cases on BBA house financing have emerged and are increasing in numbers. This posed problems to the consumers, financiers and also the regulators. To overcome this, *Musharakah Mutanaqisah* (MM) house financing concept was introduced by the Islamic financial institutions (IFI). This paper aims to identify both Islamic concept of house financing and provides insight of the pros and cons.**

Key words: Islamic house financing, *shari'ah* compliance, *Bai' Bithaman Ajil* (BBA), *Musharakah Mutanaqisah* (MM).

INTRODUCTION

Islamic finance rests on the general idea of extending tenets of Islamic religious belief to economic activity in a way that enhances social welfare. Islamic contracts are normally grounded on asset-based and it must be comply with the *Shari'ah*, which prohibits elements of *riba* (usury), *gharar* (uncertainty), *maisir* (gambling) and non-halal activities. Such prohibitions are clearly mentioned in the *Qur'an* and *Hadiths* and must be strictly adhered to the financial institutions.

Islamic finance comprising financial transactions in banks and non-bank financial institutions is said to be based on the concept of a social order of brotherhood and solidarity (Imady and Siebel, 2006). The participants in Islamic financing transactions are considered as business partners who jointly bear the risks and profits. Hesse and Sole (2008) opiniated that Islamic finance has permanently established itself within the global financial landscape. The permissibility of risky capital investment without explicit interest earning has merge the three basic forms of Islamic financing namely synthetic loans which is debt-based through sales and repurchase agreement; lease contract which is based on assets through sales and leaseback agreement (operating lease) or third-party acquired assets with purchase obligation (finance lease); and profit sharing contracts which is equity based for future assets.

The *Shari'ah* constitutes the foundation for the practice of Islamic finance through the observance of its tenets, conditions and principles. Comprehensive compliance with *Shari'ah* principles would bring confidence to the general public and the financial markets on the credibility of Islamic finance operations. The *Shari'ah* is the Islamic

*Corresponding author. E-mail: rohana799@salam.uitm.edu.my. Tel: +60355444987. Fax: +60355444921.

law of human conduct which governs business matters. Due to the probation of certain elements in the transactions, Islamic financial institutions have to develop financial products which confirm to *Shari'ah*. This may result in having a mirror product that conventional financial institution already have in their pipeline. As an example, the housing loan facility in the conventional banks which is based on interest, whereby an Islamic financial institution will have the same product named as house financing (loan denotes interest element) which uses the contract of either *Bai' Bithaman Ajil* (BBA) or *Musharakah Mutanaqisah* (MM). This is said to satisfy the *Shari'ah* as well as the customers' need. Restyling the existing product has created numbers of special product in the market (Ali and Ali, 1994). With these new innovative products, the relationships between financiers and borrowers are considered to be in partnership to which risk is attached instead of risk being borne by one party. The contract between the financiers and borrowers are governed by shared business risks and returns from entrepreneurial investment. This basically differs from the conventional products whereby the relationship is normally based on capital-based investment gains arising from the time value of money.

As Islamic banks increase its presence and position around the globe via the Islamic window and/or offering specific islamic financial products or full-fledged islamic licenced banks, the two important issues to look at are the legal aspect of the Islamic contract and the regulatory aspects of the Islamic financial institutions. It is therefore the aim of this paper to look at the first issue which covers the contract permissible under *Shari'ah* with specific focus given towards house financing.

Islamic banking

An Islamic financial institution (IFI) is the term used for all financial institutions that operate along the line with *Shari'ah* requirement. Generally, in order to be considered an Islamic financial institution, there must be a *Shari'ah* advisory board (SAB) composed of more than one scholar qualified to issue an opinion on the *Shari'ah* compliance of a financial product and also the operation of the institutions. There are conflicting statistics about the size and total number of Islamic financial institutions globally, but the International Financial Services London, a financial industry trade group in the U.K. estimates that as of the end of 2007, there are 280 Islamic financial institutions globally with total assets of USD729 billion (IFSL Research, 2009). While a study done by McKinsey (2007) reported the value of Islamic banking assets and assets under management is expected to reach USD1 trillion by 2010. The report also mentioned that Islamic banks grow more rapidly than the average banking sector in most countries. Shubber (2006) in his presentation mentioned that there are over 200 institutions in some 70 countries offering Islamic products and services with a value of USD300 billion assets under its management as compared to USD50 million in late 1970's.

The banking system in Malaysia consists of the Central Bank (Bank Negara Malaysia or BNM), the banking institutions and other financial institutions. BNM is responsible for the regulation and supervision of the banking system in the country (BNM, 1999). As at December 2010, there are 66 registered financial institutions (both conventional and Islamic) listed under BNM with 24 commercial banks, 17 Islamic banks, 4 international Islamic banks, 15 investment banks and 6 money brokers. All IFIs are regulated by BNM under the purview of Islamic Banking and Takaful Division. To ensure the operation of IFIs conforms to the *Shari'ah* requirements, BNM had in 2010 introduced "The Shari'ah Governance Framework" which is designed to ensure the IFIs structure, processes and arrangement of operations and business activities are in accordance with *Shari'ah*. Any act that is prohibited under the Islamic law must be reported and immediately corrected.

Islamic house financing

As a substitute product to conventional housing loan, Islamic financial institutions (IFIs) in Malaysia have introduced the Islamic house financing. Although, most people especially the consumer assumed the product as a mirror of conventional housing loan product, Islamic house financing has its own specialties. In the conventional system, housing loan is simply giving a loan to the customer. The product is interest-driven, with the interest charged to the customer over the period of payment.

Islamic house financing is an alternative financial product to substitute conventional interest-based house financing modes. In Islamic house financing, the dominant products used in a sale and purchase transaction are *Bai' Bithaman Ajil* (deferred payment sale) and *Musharakah Mutanaqisah* (diminishing partnership). BBA is a facility provided by the financier, that is, the bank to a customer to own a house, over a tenor of financing, e.g. 20 years, at a rate (either fixed, variable or mixed) determined by the financier. The financier initially buys the house from the customer at a price equal to the financing amount and sells it back to the customer, at a price plus profit margin (Meera and Abdul Razak, 2005). *Musharakah Mutanaqisah* (MM) on the other hand is based on the concept of diminishing partnership. This contract combines two basic Islamic concepts. First, the customer enters into a partnership (*musharakah*) under the concept of *Shirkat al-milk* (joint ownership) agreement with the bank. Secondly, the bank leases its share in the house ownership to the customer under the concept of *ijarah* (leasing). To better understand the subject matter, let us look at the definition of Islamic house financing based on both contracts and how it works based on how it works based on Malaysia concept.

Bai' Bithaman Ajil (BBA) house financing

The most popular type of financing by almost every Islamic bank in Malaysia is *Bai' Bithaman Ajil. Bai' Bithaman Ajil* means a "deferred payment sale". It is a mode of Islamic financing used for property, vehicle, as well as financing of other consumer goods. The underlying transactions of the BBA is said to be based on the concept *Murabaha* (cost plus) whereby the sales price is added up with the profit. Technically, this financing facility is based on the activities of buying and selling. Using this contract, the Islamic bank may finance the customer who wishes to acquire a given asset but to defer the payment of the asset for a specific period or to pay by installment. The asset that the customer wish to purchase for example, are bought by the bank and sold to customer at an agreed price. An agreed price will include the bank's mark-up profit. Once the bank and customer determine the tenure, the manner of the installments will then be concluded. The customer is also allowed to settle payment within a pre-agreed period in a lump sum. The price at which the bank sells the property will include the actual cost of the asset and will also incorporate the bank's profit margin. There is no interest charged and the extra price compensates the bank for its profit. Installments remain fixed over the period of the contract and no adjustment is made if interest rates fluctuate. The fixed monthly installments are determined by the selling price, repayment period and the percentage margin of financing.

BBA house financing is basically a trading transaction. In order for a trading transaction to be valid from an Islamic perspective, it must fulfill the following conditions and tenets: the existence of two parties who are capable of entering into contracts, that is, they must be mature and sane; an offer (*Ijab*) and acceptance (*Qabul*); a legal (*Sharie*) basis of union between the two declarations and the contractual obligations; and free from all prohibited factors (Ayub, 2007). In general, Muslim jurists hold that, intrinsically, the essential elements of a contract are threefold and if these elements are not found properly, the contract is invalid These are the form, that is, offer and acceptance (*sighah*), the contracting parties (*'aqidain*) and the subject matter (*ma'qud 'alayh*).

The BBA scheme in Malaysia is an Islamic financing facility for the purchase of a residential property on a deferred payment which is based on the *Shari'ah* concept. The Islamic banking institution earns a profit by purchasing the asset and subsequently sells it back to the customer at a mark-up price on a deferred payment basis. Under the aforementioned scheme, usually the purchaser would purchase the property from the developer and would have paid the deposit or part of the price. To complete the purchase of the property, the purchaser would normally apply for a financing. To obtain the BBA facility, the purchaser is required to sell the said property to the bank for the balance sum under a bank's property purchase agreement (PPA). The bank would then sell the same property to the purchaser under a bank's property sale agreement (PSA). The bank's selling price of the property would include the bank's profit margin as agreed to by the parties and its repayment is monthly instalments of a specified sum over a certain period. As a security, the purchaser is required to execute a charge or an assignment of the property to the bank. Figure 1 assists understanding of how BBA house financing works.

BBA is said to be popular in countries like Malaysia, Indonesia and Brunei. However, it has proven to be quite unsatisfactory to the customers and bankers (Meera and Abdul Razak, 2006). Customers are particularly unhappy when it comes to early redemption or in the event of default as BBA carries a higher financing balance as compared to the conventional housing loan. To support the above, in recent years, the Islamic financing facility under the concept of BBA has attracted numerous judicial considerations (Mohamed, 2008) with the recent case of Affin Bank versus Zulkifli said to be a signpost of BBA. Further to that, the Middle Eastern *Shari'ah* scholars disapprove BBA contract, mentioning that BBA contract is similar to the conventional loans.

As a result of the preceding discussion, some of the banks had put initiatives to introduce another house financing contract which is *Shari'ah* compliant and would be acceptable to the rest namely the *Musharakah Mutanaqisah* (MM) or also known as diminishing partnership. The contract is argued to be a better Islamic financing alternative for longer durations as opposed to the BBA contract (Meera and Abdul Razak, 2005).

Musharakah Mutanaqisah (MM) house financing

'Musharakah' is an Arabic word which literally means sharing. The origin of *Musharakah* is *Shirkah* which connotes engagement of two or more parties who have a common interest to form a partnership. Technically, *Musharakah* is a contract between the partners to contribute capital to an enterprise or a venture, whether existing or new, or to the owner of a real estate or move-able asset, either on a temporary or permanent basis. Profits generated by that venture or real estate or asset are shared in accordance with the terms of the *Musharakah* agreement, while losses are shared in proportion to each partner's share of capital.

The legitimacy of the *Musharakah* contract is based on the Qur'an, the *Sunnah* of the Prophet Muhammad (SAW) and the consensus of Muslim jurists. The following Qur'anic verse (Yusof 'Ali, 2008) generally indicates the validity of *Musharakah: "…but if more than two, they share in a third..." (Al-Nisa':12).*

The verse specifically outlines the rule of Islamic

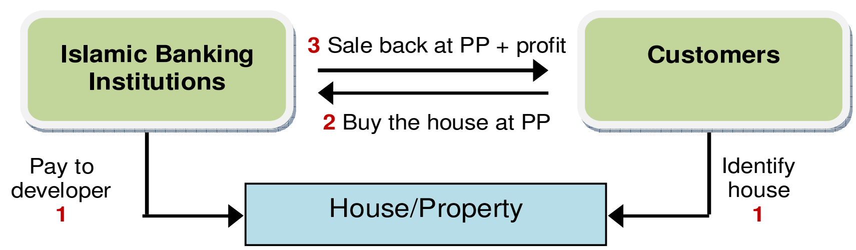

Figure 1. The structure of Bai Bithaman Ajil (BBA) house financing.

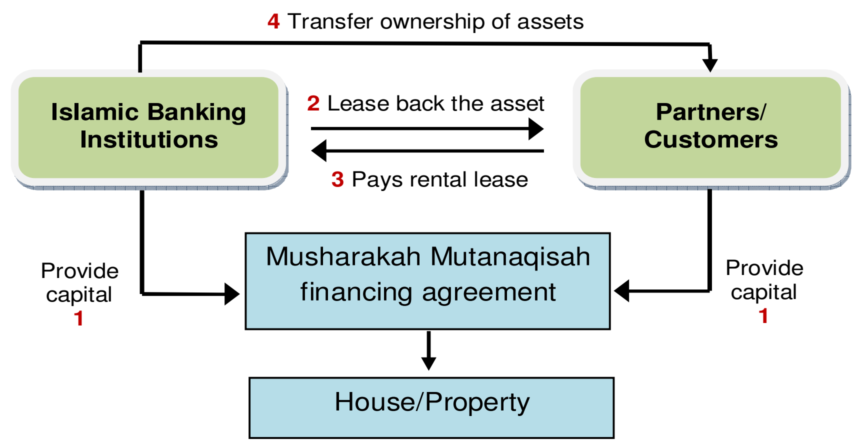

Figure 2. The structure of Musharakah Mutanaqisah (MM) house financing.

inheritance. However, in the general context, Muslim jurists have regarded the text as containing general permissibility of any form of partnership.

"Verily many are the partners (in business) who wrong each other except those who believe and work deeds of righteousness and how few of them…." (Al-Sad: 24).

Musharakah is a form of partnership which is based on profit and loss sharing. In early literature of Islamic jurisprudence, the term *Musharakah* was referred to as *Shirkah* or partnership. *Musharakah* has been practised before the Prophet Muhammad's (SAW) first revelation and since then, the practice of *Musharakah* has been assimilated as part of Islamic jurisprudence by virtue of the Sunnah of the Prophet Muhammad (SAW). *Shirkah* primarily comprises *Shirkah al-Aqad* (commercial partnership) and *Shirkah al-Milk* (joint-ownership). *Shirkah al-Aqad* refers to partnership with commercial objective, whereas, *Shirkah al-Milk* refers to joint-ownership in a particular asset. Modern application of *Musharakah* may take the form of *Musharakah* investment or *Musharakah* financing, as the case may be. Examples of *Musharakah* financing are structuring project financing, syndicated financing, asset financing, working capital financing, contract financing, trade financing and structured products based on securitization such as sukuk. One of the common *Musharakah* applications in asset financing is *Musharakah Mutanaqisah* (diminishing partnership). *Musharakah* may also be applied to acquire a stake in another entity in the form of *Musharakah* investment. The essential features attributable to a *Musharakah* contract are capital, management, profit sharing, loss sharing and a joint venture. In *Musharakah Mutanaqisah* house financing, the customer and Islamic banking institution jointly acquire and own the property. The Islamic banking institution then leases its share of property to the customer on the basis of *ijarah* (leasing). The customer, as an owner tenant, promises to acquire periodically the Islamic banking institution's ownership in the property. The customer pays rental to the Islamic banking institution under *ijarah*, which partially contributes towards increasing their share in the property. In other words, the portion of the payment proceeds or monthly instalments received from the customer shall be used towards the gradual acquisition of the Islamic banking institution's share in the jointly owned property. At the end of the *ijarah* term and upon payment of all lease rentals, the customer would have acquired all the financier's shares and the partnership will come to an end with the customer being the sole owner of the house. Figure 2 illustrates an example of house financing under *Musharakah Mutanaqisah* contract.

The concept as mentioned by Bendjilali and Khan (1995) could help the people to reduce the reliance on other financing facilities such as the BBA, *Murabaha* etc.

Table 1. The differences between Islamic House Financing concept of *Bai' Bithaman Ajil* (BBA) as compared to *Musharakah Mutanaqisah* (MM).

Islamic facility	*BAI' BITHAMAN AJIL* (BBA)	*MUSHARAKAH MUTANAQISAH* (MM)
Structure	Basically a deferred payment sale contract; buyer is given the benefit of the deferred payment and the deferred payment price of sale object carries an additional profit. Based on *Murabaha* concept of a cost plus contract, whereby the sale price (with profit) of the property is paid in installments over a long period.	Based on the diminishing partnership concept which consist of two portion: 1. The customers enter into a partnership agreement with the bank (e.g. 20%:80%) and gradually redeemed the banks portion until the house is fully own by the customer. 2. The customer agrees to pay rental to the bank. The periodic rental will be shared between the customer and the bank according to the percentage of shareholding.
Operational structure	Assist the customer paying the cost of financing during the tenor of the facility at fixed rate determined by the bank.	Property is owned by the customer while the bank participates as a financial partner (full or part) and the agreement are signed by the customer and the bank stipulates each party's shares of the profits.
	The bank buys the property from the customers and sells its back to the customer, plus it profit margin.	The bank then leases the house under *Ijarah*. The share then will be divided into a number of equal units and the customer promises to buy the individual units periodically until all are taken up (the principles of *al-Bay* under the MM contract)
	BBA documentation shows that the bank merely acts as a financer rather than a vendor.	The bank will then agree that the *Ijarah* rental is reduced in proportion to the units purchased.
	The customer does not involve the transfer of the name in the issue of document of title to the property which the buying last for a few second and in practice the selling back trough assets sale agreement is almost immediate.	The periodic payment constitutes a rental payment for the portion owned by the bank and a buyout of part of that ownership.
	It does not merit the concept of *al-Bay* and the customer is saddled with the burden of paying off the property even before it is completed as he engaged in a "debt contract".	Ownership under the MM contract is shared between the customer and the bank.
Differences	Debt type financing.	A joint ownership.
	More complicated, and buyer only can own the property right after the full payment of the full tenor has been made.	More flexible, can own the property earlier by redeeming earlier the principle sum of the bank without the need to compute the rebates.
	Recognized predominantly in Malaysia, Indonesia, and Brunei.	It is accepted internationally as *Shari'ah* compliant.
	The selling price and the bank profit do not reflect market value since the mark-up for the deferred payment is quite substantial.	The value of the property always reflects market price and rental is determined by market rental values.

Table 1. Contd.

	The return of the BBA is based on fixed selling price.	The bank needs not bind to a fixed profit rate throughout the financing tenor. The rental can be revised periodically to reflect the current market situation.
	Customer will always end paying almost four times the original cost as it may be burden for the lower-income group in particular.	There is no interest charge or advanced profit involved as it is based on the concept of rental payments and redeeming the bank's shares in the property.
	Many may be of the opinion that BBA is similar to conventional loan.	By default; 1) Partners can leave a partnership anytime, 2) The lessee in *Ijarah* arrangement will cease to pay rent once he stops deriving benefit from the use of the property, 3) Any decision relating to the proposal of the acquired property must be approved by both *Musharakah* partners.

etc. 1 Added to the point, the scholars even agreed that it is best to implement *Musharakah Mutanaqisah* for house financing whereby the property can be leased out according to agreed rental. Joint ownership of a house is accepted by all schools of Islamic jurisprudence since the financier sells its shares to the customer (Taqi Usmani, 2002). The concept of diminishing *musharakah* is not only applicable to home ownership but can also be applied to other forms of acquiring assets such as buying a car or a taxi for earning income by using it as a hired vehicle.

Both financing methods are acceptable in Malaysia as it was endorsed by the Shari'ah Advisory Council (SAC) of BNM. However, given the fact that BBA has created some questionable issues and created dissatisfaction to the customers and financiers, the move to MM contract would be a wise decision. To conclude the discussion, Table 1 provides the summary of the differences between the BBA and MM as an Islamic house financing concept.

House financing practice in Malaysia

Islamic financial institutions (IFIs) as guided by BNM include an Islamic bank licensed under Islamic Banking Act 1983 (IBA); a *Takaful* and Re-*Takaful* operator registered under the *Takaful* Act 1984 (TA); a financial institution licensed under the Banking and Financial Institutions Act 1989 (BAFIA) that participates in the Islamic Banking Scheme; and a development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) that participates in the Islamic Banking Scheme (BNM, 2010). There are currently 66 registered financial institutions (both conventional and Islamic) listed under Bank Negara Malaysia (BNM, Central Bank of Malaysia) purview with 24 commercial banks, 17 Islamic banks, 4 international Islamic banks, 15 investments banks and 6 money brokers.

In Malaysia, the BBA seems to be gaining more popularity as compared to MM. Mohd Nor (2008) mentioned that almost all Islamic banks adopt the widely used principle of BBA. Out of 17 Islamic banks in the country, eight adopted BBA contract, two applied MM contract, three banks opted to offers both contracts to add variety to their customers while another four used a safer clause of '*Shari'ah* compliant' contract. As Islamic banks in Malaysia are required to get endorsement from their internal *shari'ah* Advisory Board before getting the approval from BNM and the Central *Shari'ah* Advisory Council, such variation in the Islamic house financing product will still be under control and close supervision (BNM, 2007).. Table 2 provides insights of Islamic house financing product being offered to the public.

Conclusion

Conceptually it has been argued that house financing concept based on MM is more superior to the BBA. The argument is based on the advantages of MM which is seen to promote the welfare of the people as the outstanding balance of financing at any point in time never exceed the original price of asset (Meera and Abdul Razak, 2005). However, MM is not favourable among practitioner. It is less attractive to bankers because the MM does not charge interest of advance profits. As such the banks cannot make money. MM is purely based on rental payment. However, majority of house financing in Malaysia is using BBA and MM act as an alternative product as proven in Table 2. Both products have advantages and disadvantages to customers. In order to guide the customers to the best house

Table 2. Islamic house financing product offers by the Islamic finance institutions (IFIs) in Malaysia.

No.	Islamic bank	House financing product	Contract
1	Affin Islamic Bank	Affin Home Solution Plus	BBA
2	Al Rajhi Bank	Home Financing-*i*	*Shari'ah*-compliant
3	Alliance Islamic Bank	Wish Home Financing-*i* Wish Flexi Home Financing-*i*	BBA BBA
4	AmIslamic Bank	Home Financing-*i* Flexi Home Financing-i	BBA BBA
5	Asian Finance Bank	Home Financing-i	*Shari'ah*-compliant
6	Bank Islam	Baiti Home Financing-*i* Wahdah Home Refinancing-*i*	BBA BBA
7	Bank Muamalat	Home Financing-*i*	*Shari'ah*-compliant
8	CIMB Islamic Bank	Home Financing-*i* Flexi Home Financing-*i* Ijarah Property Financing-*i*	BBA BBA Ijarah Muntahiyah Bittamik
9	EONCAP Islamic Bank	Housing Financing-*i*	BBA
10	Hong Leong Islamic Bank	Hong Leong Flexi Property Financing-*i*	BBA
11	HSBC Amanah Malaysia	HomeSmart-*i*	MM
12	Kuwait Finance House (KFH)	*Musharakah Mutanaqisah* Home Financing-*i*	MM with Ijarah
		Home Financing-*i* i) Istisna' Home Financing-*i* (under construction) ii) Murabaha Home Financing-*i* (completed property)	BBA i) Istisna' ii) Murabaha
13	Maybank Islamic	Home Financing-*i* Home Financing-*i*	BBA MM
14	OCBC Al-Amin Bank	Property Financing-i	*Shari'ah*-compliant
15	Public Islamic Bank	ABBA Variable House Financing-*i* (prescribed) ABBA Variable House Financing-*i* (non-prescribed)	BBA BBA
16	RHB Islamic Bank	Equity Home Financing-*i* Equity Commercial Property Financing	MM MM
17	Standard Chartered Saadiq	JustHome-i	BBA

financing product, they must understand the contract including their rights and responsibilities. Customers need to be informed by the bankers on their rights and responsibilities. Failure to have the necessary information may lead to injustice to customers which is an act that should be avoided.

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