

**THE ISLAMIC HOME FINANCING IN MALAYSIA
ISTISNA' BASE ON DEBT: QUALITATIVE
APPROACH**

Mohd Faisal Ibrahim ¹, Rosila Kamarudin ^{2*},

¹⁻² Faculty Economics and Muamalat, Universiti Sains Islam Malaysia

ABSTRACT

Malaysia's Islamic Finance industry had existed for more than thirty (30) years, continues to grow rapidly supported by conducive environment, comprehensive financial structure, and adopted global regulatory and legal best practices. Today, the Islamic finance industry is considered to be a dynamic industry, which is a competitive alternative to conventional financing. This paper attempts to provide an explanation of the method of Islamic home financing in Malaysia, focus on the Shariah compliant modes on home ownership that are currently exist al-istisna'. These contract is defined as a contract to purchase now and for a definite price. Houses that may be manufactured or constructed later, according to agreed specifications. The house under istisna' is often not available now. However, will be made later by the contractor. Therefore, the focus to enhance al-istisna' contract theories into application especially for the housing industry. Istisna' is rightest comparatively to Bai Bithamin Ajil (bba) and Musyarakah Mutanaqisah (mm). The contract does not given the opportunity in the practice. Problems arise such as incomplete housing issues are able to solve by furthering the application of Istisna'. This study uses a qualitative approach. Currently, in Malaysia the Islamic Banks are exercising the most famous form of house financing bba home financing. Bba has started implementing since 1993. While others practice mm. This concept of home financing has been implemented since 2000. Hence this study analyses Istisna' as an alternative contract. Thus, Istisna' is an alternative for Islamic home financing.

Keywords: Islamic home financing, Al-Istisna', Debt financing

* Corresponding author: Rosila Kamarudin, Faculty of Economics and Muamalat, Universiti Sains Islam Malaysia. E-mail: rosila_kamarudin@yahoo.com

Introduction

The religion of Islam embraces all aspects of a Muslim's life, including the way finance and business dealings are conducted. One of the most fundamental and most widely understood tenets of the religion is that the payment or receipt of interest is strictly forbidden. Islam condemnation of interest is found in various places in the Quran and also in various hadith.

This means that conventional mortgage products are unsuitable for Muslims because lending of money for later repayment. Nowadays, Islamic banks in Malaysia and religious scholars have developed a number of ways to provide finance and banking facilities which are considered permissible within Islamic law.

The first Islamic bank in Malaysia, Bank Islam Malaysia Berhad was introduced in 1983 in order to provide shariah compliant financial products and services Sudin (1997). Starting from there, Malaysia now has separate Islamic legislation and banking regulations that co-exist with those for the conventional banking system. Malaysian banks currently offer more than 100 of Islamic financial products and services that use various Islamic concepts - such as mudharabah, musharakah, murabahah, bay' bithaman ajil (bba), al-istisna' and musharakah mutanaqisah (mm) (Bai' Muajjal), ijarah, qard, and al-ijarah thumma al-bay'.

In 1993, commercial banks, merchant banks and finance companies were allowed to offer Islamic banking products and services under the Islamic banking Scheme (IBS). These institutions however, are required to separate the funds and activities of Islamic banking transactions from that of the conventional banking business to ensure that there would not be any co-mingling of funds. Since then until the end of 2003, the numbers of IBS banking institutions have increased to 36, comprising 14 commercial banks (of which 4 are foreign banks), 10 finance companies, 5 merchant banks and 7 discount houses.

The aspiration to establish a comprehensive Islamic financial system has created a spill-over effect to the non-bank Islamic financial intermediaries which also started to offer Islamic financial products and services under Islamic banking scheme. Such institutions include the Takaful Companies, the savings institutions (i.e. Bank Simpanan Nasional & Bank Rakyat) and the developmental financial institutions (i.e. Bank Pembangunan dan Infrastruktur Malaysia and Agro Bank).

In October 1996, the Central Bank issued a model financial statement for the IBS banks requiring them to disclose their Islamic banking operations (balance sheet and profit and loss account) as an additional item under the Notes to the Accounts. The Central Bank also setup a National Shariah Advisory Council on Islamic Banking and Takaful (NSAC) on 1 May 1997. The council is considered as the highest Shariah authority on Islamic banking and Takaful businesses in Malaysia.

In December 1998, the term interest-free banking scheme used for Islamic windows was replaced with Islamic Banking Scheme (IBS) or Skim Perbankan Islam. In that year, all banking institutions that have Islamic windows were also required to upgrade the Islamic banking unit to Islamic banking division so as to further expand the Islamic banking industry.

Islamic banking had developed at first as component of a competitive and comprehensive market, parallel to the conventional financial system in contributing to the economic development over the past three decades and now has evolved into a complete and competitive form of financial intermediation that serves both Muslim and non-Muslim consumers and businesses. In 2008, the global Islamic Finance Industry experienced average rate of 15-20 percent annually. The global Islamic banking assets and assets under management had reached USD750 billion and was expected to hit USD1 trillion in 2010.

Research methodology

This research emphasized on qualitative approach using document research method. The secondary data was obtained from different variety of sources related to the study such as journals, Central Bank of Malaysia annual report, statistics acquired through BNM on-line services, books, and a few articles related to the study.

Debt and debt financing in Islamic perspective

Islam strongly does not allow interest-based financing, but it allows debt financing based on equity and economic justice. Hence, Islamic principle condemns the institution of *riba* in very strong words. In a way, prohibits charging interest on the use of money capital. In any and all forms it is absolutely clear that any excess earnings on money capital is *riba*.

In which is prohibited, regardless of the rate of interest, purpose of the loan and the terms and conditions of the transaction. Islam makes no distinction between interest and usury, nor does it make any distinction between consumption and production loans, to the degree as the prohibition on *riba* is concerned.

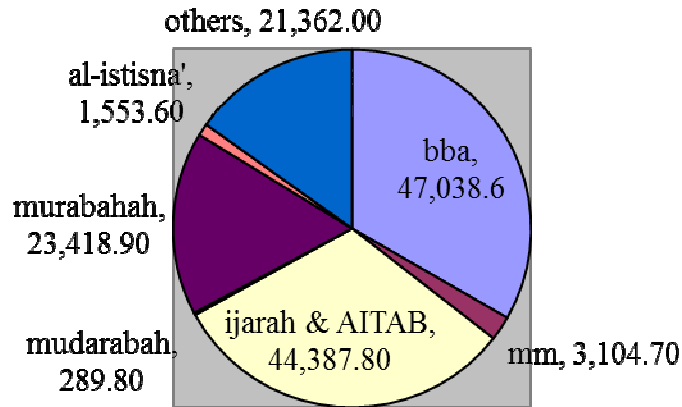
Therefore, any business arrangement based on fairness and legitimacy and on labor, skills and lawful earnings, whereby people involved assume fair business risk. It is lawful in Islam. Debt-based financing usually adopted by Islamic banks are *murabahah*, *ijarah* and *istisna'* numerous variations based on these.

The Islamic instrument concept needs to be closely understood. When, an individual entered into Islamic home financing, particularly under construction based home project. There is an extra risk evaluation to keep an eye into terms and conditions for both buyer and contractor.

Islamic Instruments Concept

The Islamic instruments which govern the operations of Islamic banks in Malaysia are also known as Shariah principles. The chart below shows some of the most common modes of Islamic financing implemented in Malaysia in April 2010 (RM Million);

Islamic Financing Principles



Source: Bank Negara Malaysia

The chart shows that the most common Islamic mode of financing are those executed through the bay' bithaman ajil (bba) which consist of RM47 038.6 millions. Meanwhile, Islamic financing using musharakah and al-istisna' are only RM3 104.70 and RM1 555.6. This data included Islamic home financing product in Malaysia offered by a large number of Islamic banks in Malaysia, such as Bank Islam Malaysia Berhad, Bank Mumalat Malaysia Berhad, RHB Islamic Bank, Maybank Islamic, and CIMB Islamic Bank.

As refer to the chart al-Istisna' is underutilized. Only RM1 555.6 is used under this contract. For the Islamic banking, this contract is suggested to concentrate to developing the industry.

Istisna' contract is providing the facility of financing in certain transactions, especially in the housing finance sector. If the client has his own land and he seeks financing for the construction of a house, the financier may undertake to construct the house on that open land, on the basis of istisna'. The client has no land and he wants to purchase the land also, the financier may undertake to provide him a constructed house on a specified piece of land.

Literature Review

Accommodation is one of the fundamental rights for by every Muslim. In Islamic perspective a house is a place for relaxation, unwinding our mind and enjoying legitimate worldly delights. According [3] Islamic house is a microcosm of Islamic culture and civilization where individuals and families are bred and nurtured, to constitute the fundamental units of the community.

Currently, selling houses under construction is a famous trend in Malaysia but unfortunately the numbers of abandoned houses are increasing Hanira and Nor Hasniah (2006). The retail Islamic banking at present, offers various schemes of home financing based on Al-Bai Bithaman Ajil Dr. Uzaimah and Safinar (2006), Dzuljastri et al (2008).

Nowadays the most famous type of house financing provided by the banks is bba home financing.

Hence, to subdue the issues of abandoned housing project Muhammad Ridwan (2013), contract Istisna' is Islamic concept as finance the ordered item will provide the seller with the working capital required to produce and deliver the ordered item. Financing under Istisna' contract mode will encourage and facilitate the under construction home. The contract gives more option to the Islamic financing products. Islamic housing is an alternative financing product to substitute conventional interest-based home financing modes.

The Bai Istisna' concept is a mechanism of buying and selling, thus this method of transacting business may overcome the element of usury or interest on any advance payment or loan provided by either party to a contract, which is prohibited in Islam Muhammad Ridwan (2013). However, in Islamic home financing, the dominant products used in sales and purchase transaction are Bai' Bithamin Ajil (deferred payment) and Musharakah Mutanaqisah (diminishing partnership) Rafidah et al (2011). The contract of istisna' places a moral obligation on the manufacturer to manufacture the goods. Either party may cancel the contract before any work begins after giving enough notice. However, the contract cannot be cancelled unilaterally if work has begun Zaharuddin (2008).

Otherwise, Bba can be defined as the sale of an object against an obligation to provide payment on a future date whereby the price of house is paid by installment Norhasyimah (1997). It is also a contract for financing sales by deferred installments and bba financing are currently applied in almost all financial instruments in which consumer and trade financing are involved Saiful (1999).

Al-istisna' can be used for providing the facility of financing in certain transaction, especially in Islamic home financing sector Hasnira and Nor hasniah (2006), MPS (2007) is a sales and purchase contracts involving the manufacture, production or construction of certain assets to the specifications of the conditions agreed between the sellers, developers and customers. Currently in Malaysia, parallel istisna' (better known as al-istisna' muwazi) used in the manufacturing sector and construction Zaharuddin (2009). Al-istisna' considered permissible within Islamic law Zaharuddin (2009).

Comparative to Musharakah mutanaqisah (mm) concept has been proposed to substitute bba for its esteemed features Dzuljastri et al (2008) BBA has drawn many criticism on its pricing of the home financing notably its dependence on as a benchmark. For example, when the interest rate is low the bba home financing amount will be expensive compare than conventional loan. Consequently, the musharakah mutanaqisah was introduced to overcomes the main criticism of bba on forcing bank to take the risk of ownership progressively pass the ownership to customer Fauziah and Ramayah (2008).

Clients pays ten (10) percent for house under construction worth RM 100 000 that is expected to be completed by 1st January 2009. According to majority of scholar, the customer may already offer his house under construction for sales – known as Istisna' Mawazi The customer will then look for financing Zaharuddin (2008). The bank will buy the house under construction from the client at a price of RM 90 000 either with deferred payment until the house is ready, or via spot settlement. Client promises to

deliver on 2nd January 2009.

Both payment methods are acceptable in Syariah. When the house is completed, it will be owned by the bank and the customer must promise (from the initial stage) that they will lease the house from the bank starting on 2nd January 2009. Thus on 2nd January 2009, a leasing contract for 25 years will be entered into. This is *Ijarah Thumma Al-Bay'*. It ends when lease ending with selling. It shows that Istisna' contract is practical to implement especially in the housing industry.

Discussion

Islamic home Financing based on debt instruments

An Islamic perspective, home is a necessary goods and a basic necessity for human life. Every human needs a shelter and comfortable place to sleep, rest, and protection from storm, thunder, sun and rain. People try to fulfill this need by owning their home, whether by purchasing it or renting it from others. Nowadays, Islamic banking institutions have introduced a few numbers of Shariah compliant modes for home ownership.

Al Bai Bithaman Ajil is a contract with deferred payment sale and mode of Islamic financing used for property and others. Practically, this financing facility is based on the activities of buying and selling. The house that to purchase are bought by the bank and sold at an agreed to price. The bank will determine the tenure and the manner of the instalments. The price at which the bank sells the house will include the actual cost of the house and will also incorporate the bank's profit margin.

Therefore, there is no interest charged and the extra price compensates the bank for its profit which is prohibited by Syariah. 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. However, the disadvantages of BBA the selling price and the bank profit do not reflect market value since the mark-up for the deferred payment is substantial. Critics of this concept have accused that the BBA practiced is seen not to be in compliance with the Shariah principle as the bank does not take the risk of ownership and liability of the property and thus not acceptable by international scholars.

On the other hand, *murabahah* is a transaction in which a buyer purchases house at a profit margin agreed by both buyer and bank. The profit made by the bank is not regarded as a reward for the use of capital. It's not permitted to rent out money with interest. *Riba* will included in transaction. Instead, these contract seen as a profit on the sales of the house. Hence, it is important as well to determine by mutual consent either of a lump sum or through an agreed ratio of profit. There will be charged above the cost of the house. The disadvantages of *Murabahah* contract are not applicable in all housing contracts. It is particularly, when the price of the houses cannot be determined.

However, to possessed a house in Malaysia nowadays can cause the customer half million for a an average apartment in specific in Klang Valley. Even, a terrace link house in Mantin in Negeri Sembilan, fifty kilometer (km) the nearest state to Klang Valley cost the same price. Therefore, customer preferred to give the chance to have the ability to forecast. By doing so, the customers are taking the planning to take risk to own a house.

Nevertheless, the price under construction must at a level affordable to buy. For a buyer to buy a house is taking a risk in their financial process. Furthermore, they intend to buy house under construction. The commission to manufacture contract is concluded through the offer and acceptance of the buyer and seller or manufacturer. The technical Arabic terms are thus: the contract is *istisna'*, the buyer is called *mustasni*, the seller *sani*, and the object of sales is called *masnu* Dr. Wahbah Zuhayli (2002).

All of the parties involved benefited from the *Istisna'* the buyer, contractor and also financial institution. Especially, the house or building is under construction. Financing under this mode will encourage and facilitate the full use of the talent and technical capability, it will enhance intra-trade in goods and transfer of technology. Thus, lack of financial capital, thus, may not be an impediment for production of capital goods. However, this applies to the housing industry as well. By offering the product that are suited customer that are needed the debt-financing, it will boost the profit of the financial institution. The construction industry was the field where *Istisna'* has play prominent role and where the investment of a single Islamic bank reached billions. Thus, *Istisna'* has solving one of the crucial contemporary problems.

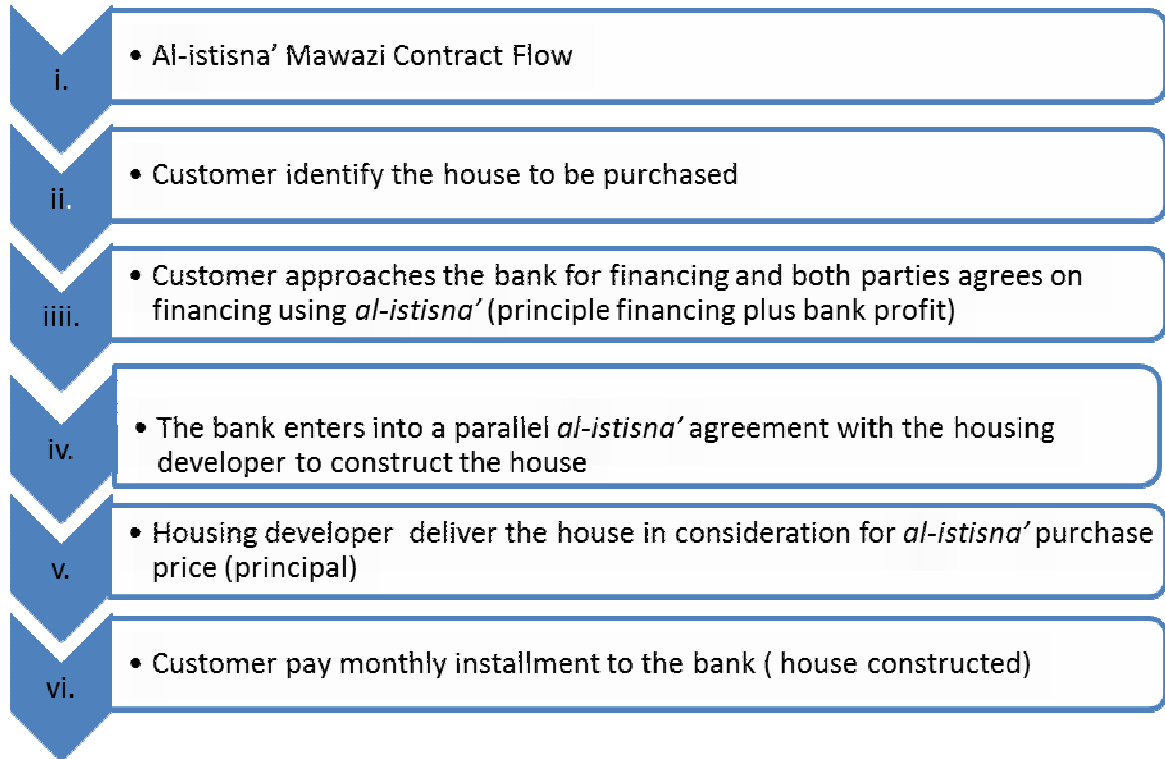
The constructions industry includes building, apartments, hospitals, schools, universities, canals and whatever constitutes the network of modern life. Thus *istisna'* can be utilized in in financing infrastructure projects that cannot easily lend themselves to be finance by way of leasing and installment Muhammad Al-Bashir (2006). By taking these advantages of *Istisna'*, be able to solve many issues arise in BBA and *murabahah*.

The detail mechanism (suggested) of the structure and its in relation to Islamic home financing instruments are detailed below;

Mechanism of Manufacturing (*Al-istisna'*Mawazi) Home Financing

Al-istisna' is one of the contemporary innovative products in Malaysia. Kuwait Finance House Malaysia Berhad was the first bank that initiated *al-istisna'* in Malaysia. Scholars are consensus on the shariah permissibility of the *al-istisna'* contract. *Al-istisna'* home financing product refers to parallel *istisna'* because of there are two contract in islamic home financing. The first contract is a agreement between customer and bank, second

contract is a agreement between bank and housing developer. The process flow of istisna' contract identified as below:



The customer identifies the house to buy. The seller provides the price quotation and other relevant detail requested by the customer. Then, the customer approaches the bank for financing and both parties agrees on financing using *al-istisna'*. The bank will purchase (parallel *al-istisna'*) the house from housing developer at a principle price of, say RM500,000 and now bank will have ownership of that house. However the customer pays according to the agreed payment plan until the *al-istisna'* time period expires.

The settlement of payment under Bay' Istisna' by firstly, pay the total price at the time execution of contract. Secondly, pay the total price at the same time of delivery of the product, Thirdly, make part payment at the execution of the contract and pay the remaining balance at the point of delivery of the product and lastly, pay on an installment basis as agreed between the seller and the buyer Muhammad Ridwan (2013). Thus, to ensure the binding of the contract it is necessary to surrender the amount of down payment for third and fourth types of settlement. Usually, the agreement contract may take long term binding agreeable by all parties'.

The installment may start right after the contract Istisna' is signed by the parties, continues during the construction of the house and after handed over to the client Hanira and Nor Hasniah (2006) .The calculation cost of the financier and fix the price plus his 'reasonable' profit over his cost.

Al-istisna' Financing (Proposed calculation)

Consider the following example for the purpose of further understanding. Al-Qisi approaches the MOFAISIB Islamic Bank and applies for financing under the concept of al-istisna'. Let say the purchase price for the house is RM600,000 and profit rate is 10 per cent. Customer downpayment is 10% from house price (RM60,000). Al-Qisi agrees to a financing tenure of 30 years and is willing to pay rental in monthly installment. The computation is as below;

$$\begin{aligned}
 \text{Annual instalments} &= \frac{i(1+i)^n PV}{(1+i)^n - 1} \\
 &= \frac{0.10(1+0.10)^{30} \langle RM600000 - RM60000 \rangle}{(1+0.10)^{30} - 1} \\
 &= RM52,282.87 \\
 \text{Monthly instalments} &= \text{Annual instalments}/12 \text{ months} \\
 &= \frac{RM52282.8}{12 \text{ months}} \\
 &= RM4,356.90 \text{ per month} \\
 \text{Total Payment} &= RM4356.9 \times 30 \text{ years} \times 12 \text{ months} \\
 &= RM1,568,486.10
 \end{aligned}$$

As a result the total payment is RM1,568,486.10 and the monthly payment for the period of 30 years is RM4,356.90. However in Malaysia, al-istisna' home financing product offered for the house under construction but bba financing product offered for the house under construction and houses constructed. Currently, al-istisna' home financing is not appealing to banks as compared the bba and musharakah mutanaqisah home financing. The suggested calculation is similar calculation to BBA because the installment element in BBA and Istisna'. On the other, syariah compliance is Istisna' is allowable for home under construction.

Benefits of under construction houses

An Islamic perspective, Istisna' as debt financing. For a buyer to buy a house is taking a risk in their financial process. Furthermore, they intend to buy house under construction. The commission to manufacture contract is concluded through the offer and acceptance of the buyer and seller or manufacturer. The the technical Arabic terms are thus: the contract is istisna', the buyer is called mustasni, the seller sani, and the object of sales is called masnu Dr. Wahbah Zuhayli (2002).

Istisna' is a special type of sale contract. There are three primary sale contracts in traditional Islamic fiqh, from the perspective of financing. First, are common sale contract, whereby a good and its money price are simultaneously exchanged. No loan is involved either for the seller or the buyer. Sale for a deferred price. The seller finances the buyer, because he delivers the good now, for a price to be paid later Muhammad Anas Zarqa' (1997).

Istisna' should apply in the home under construction. Since the housings' pricing is increasing every year. Buying a house under construction is a riskier to the customer and the contractor. Therefore, sales and purchase of non-existent or a house that is still under construction treated as gharar should revise. As the uses of this contract have no restricted to the traditional industrial production, but has also extended to the construction sector, thus providing an important tool in solving a serious problem in many Muslims countries Rafidah et al (2011). Bank will increase the sales based on istisna'. In the other ways it can increase the sales of Islamic based contract. Furthermore, this will increase the awareness of society to Islamic banking and finance. Therefore, buying a house under istisna' can be risky to the buyer.

Even though, the structure of the house is seventy percent (70%) completed, but the contractor can sell the home before its completed hundred percent (100%). Islamic Banking and finance as whole will benefit from this research. This will increase the awareness of Islamic Banking contract. There are other options, other than current contract available in the market.

According to Muhammad Al-Bashir (2006), Istisna' contract will contribute to the reduction of unemployment. Moreover, there is no doubt that the increase of the demand has a great economic effect by expanding economic activities, opening new areas of competitiveness, creating new jobs and enlarging market. Thus istina' allows the involvement of many parties in the production.

Advantages Istisna' contract financing

The buyer is that taking the risks by buying the house under construction. However, as Muslim it is our responsibility to ensure that all contract is signed is free from riba (usury) and gharar (uncertainty). The fundamental ruling in the affairs of muamalat is based on its reasons and objectives Zaharuddin (2008). Islamic scholar, Al Ghazali, the very objective of Maqasid Shariah is to promote the welfare of the people, which lies in safeguarding the faith, life intellect and posterity and wealth Dzuljastri et al (2011).

It is reported that home financing is the largest financing service in Malaysia. Hence, home financing is noteworthy segment of investments in our presence banking practices. It shows that, religiosity is the main important fact that influence the intention to undertake Islamic home financing in Klang Valley. Therefore, our believe in Islam is strong factors that determine a buyer to choose an Islamic financing Syed Shah Alam (2012).

Therefore, Istisna' contract should market by the Islamic financial institution to promote more under construction house and building. It can be used for providing of financing in certain transaction especially in the house finance sector. Since it is not necessary in istisna' that price is paid in advance, nor is it necessary that is paid at the time of

delivery, (it may be deferred at any time according to the agreement of the parties), therefore the time of payment may be fixed in whatever manner they wish. The payment also is in installment Maulana Taqi Usmani (2012).

Conclusion

First, of all further research needs to be done on this particular Islamic contract Istisna'. It is an alternative contract that complies with shariah laws that need to be utilized as the construction becomes one of the important industries in the modern era that generates revenues in the smaller and larger scale of business.

Three of the most common methods of providing Islamic finance are known by the in Arabic names bay bithaman ajil, al-istisna' and musharakah mutanaqisah. Scholars and Islamic banking practitioners consider bba, al-istisna' and mm to be the most suitable finance methods for the purchasing of houses in the Malaysia. However, the maturity of Malaysian Islamic Banking it may suggest that the customer could give the chance to understand and enter the contract according to syariah laws.

An Islamic financial institution proposed a financing product for house under construction based on Istisna' and Ijarah mawsufah fi al zimmah. The modus operandi of the financing commences with the customer signing the sales and purchase agreement with the developer and pays a deposit equivalent to ten percent of the house selling's price. Subsequently, the customer will apply for a financing facility from an Islamic financial institution based on istisna' contract whereby the customer will sell the house to the Islamic financial institution based on istisna' contract (parallel istisna'). This stated in Shariah resolution in Islamic Finance. The resolution the SAC, in its 68th meeting dated 24 May 2007 has proposed house financing product based on Istisna' muwazi, ijarah mawsufah fi al-zimmah and ijarah muntahia bi al-tamlik is permissible Central Bank of Malaysia (2012).

The inexistence of the house is no longer a factor to stop from buying a house. The customer approaches the bank for obtaining an asset on lease. The customer undertakes to make periodic lease payments for the lease period. Lease agreement and agency agreement is signed. The customer as an agent to the bank buys the asset. Bank receives the title of the asset and pays the vendor. The bank leases the asset and the customer starts using the asset and pays rent for each period. In the end, the customer can purchase the asset from the bank by way of a separate purchase agreement. Istisna' is used in financing goods that are not yet ready for sale and have to be manufactured first.

No riba once houses completed contract based on Istisna'. The buyer is that taking the risks by buying the house under construction. However, as Muslim it is our responsibility to ensure that all contract is signed is free from riba (usury) and gharar (uncertainty). The fundamental ruling in the affairs of muamalat is based on its reasons and objectives Zaharuddin (2008). Al Ghazali, the very objective of Maqasid Shariah is to promote the welfare of the people, which lies in safeguarding the faith, life intellect and posterity and wealth Dzuljastri et al (2011).

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