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## Article

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# Framework for financial hardship indebtedness management in abandoned housing projects in Malaysia

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## Abstract

**Purpose** – This paper aims to examine the existing practices and pertinent issues affecting Islamic banks and their customers in abandoned housing projects (AHPs) to ensure compliance with Shari'ah and statutory requirements.

**Design/methodology/approach** – This study employs the qualitative research method using the inductive approach to analyze both primary and secondary data and sources. Data collection involved a series of semi-structured interviews with five volunteering Islamic banks and a representative of Abandoned Property Owners Association Malaysia (Victims). Statutory acts, regulatory policies, guidelines, directives and standards were also analyzed.

**Findings** – The result indicates developer's default, underlying contracts, regulatory arbitrage and bureaucracy, attitudinal disposition of customers and sell-then-build approach as major factors of AHP's conundrum.

**Practical implications** – This study has suggested both short- and long-term solutions based on the principles of justice, public interests and removal of hardship to resolve and effectively manage financial hardship indebtedness arising from housing abandonment. Further, part of the proposed solutions would also reshape housing development policies and home financing transactions.

**Originality/value** – The quest for this research demonstrated Islamic banking industry's initiatives to find lasting solutions to perennial issues of AHPs.

**Keywords** Islamic home financing, Abandoned housing projects, Financial hardship, Home buyers, Housing developer, Indebtedness management

**Paper type** Research paper



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## Introduction

Shelter as a basic human need underlies the efforts exerted by prospective home buyers and other stakeholders in housing development projects. Thus, incomplete home construction projects – technically known in Malaysia as abandoned housing projects (AHPs) – beget issues and challenges, especially to key stakeholders like home buyers, banks, the community, the government and the environment.

According to the National Housing Department under the Ministry of Urban Wellbeing, Housing and Local Government (KPKT), as of 31 March 2017, there were about 64,290 housing units that had been declared AHPs in Peninsular Malaysia. The units were in 253 housing projects and involved about 43,538 home buyers. Of this number, about 188 housing projects (74.3 per cent), involving more than 48,000 housing units, have been resuscitated, while the rest (25.69 per cent) are still under the revival process (KPKT, 2017).

The issue of AHPs is not peculiar to Islamic banks. Still, both ex-ante and ex-post facts relating to AHP financing by Islamic banks in Malaysia and the effect on prospective home buyers necessitate a study of this pertinent issue. This research emanates from an industry initiative undertaken jointly by the Association of Islamic Banking Institutions Malaysia (AIBIM) together with the International Shari'ah Research Academy for Islamic Finance (ISRA). The aim was to examine relevant issues affecting Islamic banks and their customers because of AHPs.

This paper examines the existing practices of Islamic home financing and related matters to ensure that such activities are in line with the statutory requirements of the [Islamic Financial Services Act \(2013\)](#) (IFSA). IFSA prescribes an end-to-end Shari'ah compliance process in the activities, operations and business of Islamic banks, hence substantiating the importance of this study. This initiative is timely as it addresses issues concerning AHPs in the industry. The outcome of this study proffers proposed short- and long-term solutions for an indebtedness management framework for Islamic banks and customers involved in AHPs.

## Research objectives

This paper aims to realize the following objectives:

- To study Shari'ah issues in the existing practice and treatment given by Islamic banks to their customers in AHP.
- To enhance the existing practice and treatment given by Islamic banks to their AHP customers in line with Shari'ah principles.
- To propose a guiding framework for financial hardship indebtedness management in AHP.

## Research methodology

This research employs the qualitative research method using the inductive analysis approach. Data collection involved both primary and secondary data. The primary data included semi-structured interviews, as well as statutory laws, regulatory guidelines and policy documents. Through a series of semi-structured interviews conducted from January 2017 to March 2017 with five Islamic banks in Malaysia, pertinent Shari'ah issues have been identified. The representatives of the five Islamic banks include officers from Shari'ah, legal, recovery, product and finance departments. In addition to

these, the President of the Abandoned Property Owners Association Malaysia (Victims) has been interviewed.

The issues identified through these interviews are analyzed by examining and referring to the relevant existing laws – in particular, IFSA, [Consumer Protection Act \(1999\)](#) (CPA), [Housing Development \(Control and Licensing\) Act \(1966\)](#) (HDA) and Bank Negara Malaysia (BNM) Policy Documents. Primary and secondary sources of Sharī'ah (Islamic law) such as the Qur'ān, the Sunnah and *maṣlahah mursalah* (public interest) have also been used. Other references include the resolutions of the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (IFA-OIC), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2015), the Shari'ah Advisory Council of Bank Negara Malaysia (SAC) as well as other literature and conference proceedings.

### **Key findings and discussions**

A number of key findings have been identified through the interviews of the participating respondents regarding the genesis of AHP, treatment of the customer by Islamic banks, Sharī'ah concepts applicable to Islamic home financing and the relevant legal and regulatory framework affecting AHPs. The key findings from the fieldwork can be categorized into five themes, discussed as follows.

#### *Developer's default*

A party at the center of the prevailing and seemingly perennial problem of AHPs in Malaysia is the developer. In the event of default by the developer – in which case the house is not delivered to the customer – the Islamic bank would still have a claim on the same customer for money disbursed. Meanwhile, the defaulting developer is not pursued. The customer is caught in a double bind: they are indebted to the bank without obtaining any housing asset from the developer.

It is noted in the literature and corroborated by interviewees' comments that developers have many reasons for defaulting. It is likely that no developer plans to abandon a housing project. However, more often than not they run into cash flow problems that frustrate the completion of a project. This cash flow problem arises because a developer may need to have as much as an 80 per cent sales percentage to obtain bridging finance. When there is no bridge financing, the initial down payment by prospective home buyers serves as the main source of cash flow. In other instances, improper feasibility studies and market research and lack of financial management skills are argued to have resulted in delay or non-payment of contractors, suppliers, workers and others. All these factors contribute to developer default.

The lack of any formal or legal relationship in the present arrangement that connects the three transacting parties – namely, customers, banks and developers – is the fundamental flaw contributing to the AHP conundrum.

#### *Underlying Sharī'ah contracts*

Banks are financial institutions with dual obligations of liquidity to their depositors and profitability to their shareholders. Nevertheless, it may be expected that such obligations would be balanced by the underlying risk-sharing philosophy of Islamic banking and finance. Islamic banks' risk-avoidance outlook to Islamic home financing led to the historically predominant use of *bay' bithaman ājil* (BBA) (deferred payment sale) as the underlying Islamic home financing contract. This contractual arrangement inadvertently gave rise to problems between Islamic banks and their customers in the

wake of AHPs. Most of the AHP issues involving Islamic banks are legacy AHPs inherited from their previous Islamic banking windows where BBA was the prevalent contract for Islamic home financing. Islamic banks have since stopped using BBA and are now mainly using *tawarruq* (tripartite sale) as the underlying Islamic home financing arrangement. No AHP cases have arisen yet under the present financing regime. However, the fact that alternatives like parallel *istiṣnāʿ* (construction contract), *ijārah* (lease) and *mushārakah mutanāqīṣah* (diminishing partnership) financing are presently unused or underused is an indication of Islamic banks' risk-avoidance disposition.

Other likely causes may be that there are no other contracts in use which are independent but complementary to the Islamic home financing contracts. For instance, incorporation of *wakālah* (agency) agreement between Islamic banks and their customers in the *tawarruq*-based home financing agreement – that would enable the former to engage with the developer directly – is not favored by banks. Similarly, the novation agreement that was once used under the BBA-based home financing arrangement has met with a cold response from developers. Perhaps, these additional arrangements would add to the legal responsibilities without enough remuneration to justify the efforts.

Having said that, based on the interviews, the banks do not mind the inclusion of a home completion *takāful* (Islamic insurance) (HCT) policy to be obtained by the developer on behalf of the home buyer as part of the requirement to provide financing. This is in line with the suggestion of the “Special Task Force to Facilitate Business,” whose Malay acronym is PEMUDAH. However, some of the issues raised as likely impediments included:

- the increased financing requirements by customers;
- willingness of small developers to accept such additional requirements; and
- request for exemption by renowned developers and regulatory requirements for enforcement.

A Sharīʿah-cum-legal issue here is to come up with possible alternative Sharīʿah-compliant modes of financing that reflect the sale and purchase of the subject matter and that does not fully exonerate the banks or developers from sharing the risk in the event of AHP. The master agreement should include complementary contracts like *takāful* coverage and a *wakālah* agreement with detailed explanation of who bears the cost, who has performance responsibility and who bears the risk of non-performance.

#### *Sell-then-build concept*

The current system of sell-then-build (STB) also accounts for the incidence of AHPs in Malaysia. Arguably, the system allows for houses to be built at a much quicker rate. Still, this is predicated on the often overstretched assumption that economists called *ceteris paribus* (other things being equal). There are usually unintended consequences, such as AHPs, at the slightest change in the fundamentals that underpin the projections for building construction. This is especially the case with small and relatively unknown developers.

The STB system allows small developers to come on stream – which apparently has positive implications for the socio-economic development of the country and its aspirations of providing affordable housing for all. However, the Achilles' heel of the system is the possibility of buying and selling a subject matter that does not exist. The developer is the primary beneficiary of this system as he gets quite a large chunk of his financing even

before he delivers the house. At the same time, he has no direct financial obligation to the bank except when bridging finance has been obtained.

Based on the interview responses, the bankers also seem to be favorably disposed to the present STB arrangement. This is because the financing contracts involved allow them to claim from the customers even if the developer fails to deliver. The bank still has the contractual right to secure payment for the amounts disbursed. Moreover, the argument is made that houses would cost more under the alternative build-then-sell (BTS) system, which would make house purchases unaffordable for most customers. There is a dissenting view, however, that adopting BTS – as suggested by PEMUDAH and practiced in regions like the Arabian Peninsula – would go a long way in resolving the problems arising from AHPs. This is argued to be closely aligned with the tenets of Islamic financing, as the product being bought and sold exists in its physical form. This would make the bank deal directly with the developer by financing the completion of the housing project. Furthermore, the bank would also deal directly with the customer by buying and selling an existing asset in the form of a completed house.

The Sharī'ah-cum-legal issue that arises is how a BTS system, as practiced in the other climes, can be adopted in Malaysia in a way that factors in the local peculiarity of housing needs, socio-economic realities and inequality.

#### *Attitudinal disposition of customers*

Customers' attitudinal disposition, according to the respondents, is responsible for the incidence of AHP and the unintended consequences they have had to bear thereafter. Some respondents said that the onus is also on customers to make consistent spot checks on their on-going construction properties. They should inform the banks to stop payment if they observe any irregularities or stay of work on the site by the developers. However, customers at times fail to perform this duty due to their complete trust in the developer to deliver or because the property in question is not their first home. Furthermore, some customers seem not to take Islamic banks seriously. They have an illusion that, being an Islamic bank, funds disbursed to the developers may not need to be refunded or that Islamic banks should be more forgiving of debts. This may frustrate any possibility of discussion between the customers and the banks to refinance or restructure for the purpose of project rehabilitation.

#### *Regulatory arbitrage and bureaucracy*

There were also insinuations in the interviews that regulatory agencies involved in home financing and development allow developers to take advantage of gaps in the system. For instance, it is possible for defaulting developers to re-register under another name. Also, the definition of what constitutes an abandoned project may allow for a recognition lag. If not for that lag, AHPs could be nipped in the bud much sooner.

#### **Key Sharī'ah principles**

The guiding framework proposed in this research is formulated based on the following three fundamental Sharī'ah principles:

- *Ensure adherence to justice in treating and dealing with AHP customers:* This principle is in line with injunctions on justice from both the Qur'ān (16:90) and the Sunnah. Justice in Islam covers all human conduct and interactions and does not differentiate between people in its implementation.

- *Safeguard public interest through the establishment of an environment supportive to affected parties in AHPs:* The principle of safeguarding public interest ranks in highest priority in the field of Islamic legal rulings. It refers to the consideration of the well-being of people in every aspect of life including commercial transactions.
- *Ensure removal of hardship from affected parties through joint efforts to eliminate or minimize the effects of AHPs:* The principle of removal of hardship refers to elimination of any conduct that leads to difficulties and harm to body, life or property at present or that is likely to do so in the future. In the context of Islamic banking, its products and services should be structured and organized in a manner that eases the daily needs of the public and enhances the lifestyle and well-being of individuals and the public in general.

### Conclusion and recommendations

The paper concludes that acute effects of financial hardship indebtedness arising from AHPs can be effectively managed based on three fundamental Sharī'ah principles, namely, justice, public interest and removal of hardship. In view of the findings highlighted above, both short- and long-term solutions have been recommended based on the Sharī'ah principles to address the financial hardship of AHP customers and enhance existing practices and the treatment of AHP customers by Islamic banks. The short-term solutions mainly deal with the bank–customer relationship. The long-term solutions comprise policy amendments and enhancements as well as the establishment of AHP customers' protection funds and home completion *takāful* certificates.

#### *Short-term solutions*

- (1) It is recommended that Islamic banks adhere to [BNM \(2011a, 2011b\)](#) *Ibra'* Guidelines and act compassionately and justly in the recovery process that involves AHP customers:
  - To ensure that para 8.11 of the *Ibra'* Guidelines covers abandonment scenarios that occur more than once, it is recommended to delete the word “first” as recommended herein: “[. . .] Islamic financing institutes are allowed to claim the accrued profit portion of financing up to the date of the ~~first~~ sign of inability to deliver the asset [. . .]”.
  - To ensure Sharī'ah compliance of the recovery process, Sharī'ah risk management, Sharī'ah research unit, Sharī'ah review unit and Sharī'ah audit in consultation with Sharī'ah Committee should review *ibrā'* (rebate) implementation in recovery actions.
- (2) The treatment of AHP customers varies from one Islamic bank to another. Some adopt a more compassionate approach by exempting AHP customers from their monthly installments during the abandonment period. Others adopt a stern approach and even take legal actions, thus resulting in the bankruptcy of AHP customers. It is therefore recommended to adhere to regulatory requirements which comply with Qur'ānic injunctions:
  - “If the debtor is in difficulty, then delay things until matters become easier for him; still, if you were to write it off as an act of charity, that would be better for you, if you only knew” (Qur'ān, 2:280).

- Para 8.8 of BNM *Ibra'* Guidelines says: Islamic financing institutes are encouraged to act compassionately and to give due consideration in determining the amount of the early settlement charges, late payment charges and settlement amount paid by customers, particularly those faced with mitigating circumstances beyond their control, such as out of job, illnesses, loss of asset due to natural catastrophe or fire and abandoned projects.
  - Other statutory and regulatory requirements such as Schedule 7 of IFSA, [BNM \(2012\) Guidelines on Responsible Financing](#) and [BNM \(2016a, 2016b\)](#) policy document on *Prohibited Business Conduct*.
- (3) Para 12.1 of [BNM \(2015a, 2015b, 2015c\)](#) *Classification and Impairment Provisions for Loans/Financing* requires Islamic banks to tag any rescheduling made by customers regardless of any reasons whatsoever in the Central Credit Reference Information System (CCRIS). It is recommended to exempt AHP customers from CCRIS and grant them a moratorium that covers the period of abandonment in consultation with National Housing Development under Ministry of Urban Wellbeing, Housing and Local Government (KPKT).
  - (4) The recovery process approach adopted by Islamic banks varies as some approach their AHP customers in line with the nature of the Sharī'ah contract applicable to the financing. However, others adopt a typical lending–borrower contractual relationship. Therefore, it is recommended to have a Sharī'ah-based recovery process and a standard periodical review process to ensure end-to-end Sharī'ah compliance.
  - (5) The research recommends full disclosure of the recovery process to the Sharī'ah Committee in line with Para 21(e) and (f) of [BNM \(2015a, 2015b, 2015b\)](#) *Guidelines on the Governance of Shariah Committee* and para 2.12 of [BNM \(2011a, 2011b\)](#) *Shariah Governance Framework*.
  - (6) The Islamic home financing agreements should be fair and balanced and reflective of the true nature of Islamic banking.
  - (7) AHP customers should be treated fairly and in accordance with the nature of each Sharī'ah contract applicable in Islamic home financing. The research – apart from Sharī'ah treatments relating to the use of BBA, *tawarruq* and *mushārahah mutanāqishah* in the event of AHP – suggests that *istisna'* and *ijarah* contracts be explored in Islamic home financing.

#### *Long-term solutions*

- There is a need to revisit relevant BNM policy documents and guidelines to identify gaps or provisions to be enhanced to cater for AHPs and AHP customers.
- There is a need to issue guidelines on how Islamic banks can best treat AHP customers.
- There is a need to introduce a mechanism for early revival of the AHP by setting up a trust-based special entity like a special purpose vehicle (SPV). The SPV would be able to ring-fence the money paid for the housing construction. This would protect it from being subjected to creditors' claims should the developer go bankrupt or be wound up.



- The stakeholders should come up with a mechanism that prioritizes AHP customers/first-home buyers in the queue of creditors' claims in liquidation action of a wound-up/bankrupt developer.
- There is a need to further study the potential of *zakāh/waqf* instruments or the issuance of Social Impact *Waqf Şukūk* that could assist in alleviating the financial hardship of AHP customers.
- The stakeholders should set-up a fund earmarked for the revival of AHPs that do not meet the criteria of AHP revival funding from the government.
- There is a need to require developers to subscribe for a home completion *takāful* certificate (HCTC), as proposed by PEMUDAH, which caters for AHPs.

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