

Issues and Prospects of Islamic Hire Purchase Financing: Malaysian Evidence

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Abstract

Despite the popularity of Islamic hire purchase among the customers as an alternative for conventional hire purchase, the criticism especially on issues pertaining to its legitimacy and validity should not be overlooked. This study therefore, aims to highlight several issues and prospects of Islamic hire purchase Ijarah Thumma al Bai' (AITAB) in Malaysia and subsequently, provides a comprehensive exploratory study on the various ways to have a better and more legitimate structured AITAB in financial institutions. Descriptive and analytical research method had been applied in this study to analyze the collected data. The findings point out the limitations of AITAB implementation such as Shari'ah framework, ownership, maintenance responsibility, deposit payment, penalty in case of default, intention and lack of understanding of parties, signing of two separate documents in sequence, and interest-based calculation of profit. The findings also indicate the endless prospect of AITAB in Malaysia due to its strong public acceptance, competitiveness, and religious inclination. It is hoped that issues pertaining to Islamic hire purchase can be resolved through having Shari'ah regulation. Therefore, efforts should be strengthened to offer practicable solutions to help provide better and more legitimate structured implementation of Islamic hire purchase in financial institutions.

Keywords: Islamic Hire Purchase Financing, Issues of Islamic Hire Purchase, Prospects of Islamic Hire Purchase, Conventional Hire Purchase, Hire Purchase Act (HPA)

Introduction

Over the last decade, Islamic hire purchase financing which is recognised as Al-Ijarah Thumma Al-Bay' (AITAB) became the most demanding product provides by the Islamic banks in Malaysia. Bank Islam Malaysia Berhad is the first Islamic bank in Malaysia that has implemented AITAB in 1995 (Abdullah and Dusuki, 2004). AITAB became a popular and demanded product as an alternative for conventional hire purchase since its first commencement in more than 10 years ago. Conventional banks in Malaysia are also operating AITAB under Islamic banking scheme due to the growing demand by the customers. Despite being one of the most popular products of the Islamic banks, AITAB is being criticized by many people due to its lacking in explicit *Shari'ah* regulatory framework (El-Din and Abdullah, 2007). Critics argue that Islamic hire purchase financing (AITAB) is simply a carbon copy of the conventional hire-purchase instrument as it is mainly based on the conventional Hire Purchase Act 1967. As researchers Ismail (1999) has explained, any dispute pertaining to the transaction of Islamic hire purchase refers to the conventional regulations as there is no written *Shari'ah* law that specifically regulates the operation of AITAB. Therefore, any institution that offers AITAB tend to impose its own rules and regulations, which merely follow *Shari'ah* principle and the Hire Purchase Act 1967 and Contract Act 1950 (El-Din and Abdullah, 2007). Despite of having no specific regulatory law on AITAB transactions, some banks manage to offer it successfully following the Hire-Purchase Act 1967 which is not entirely contradicted by *Shari'ah* principles (Haneef, 1997). But this view has criticized: many Islamic scholars now consider AITAB as conventional product rather than Islamic product, influenced by many non-*Shari'ah*-compliant factors. El-Din and Abdullah (2007) have further noted that the practice of AITAB in Malaysia does not seem to be 100% *Shari'ah*-compliant because it involves several issues like *Shari'ah* framework, ownership, transfer of ownership, maintenance responsibility, insurance responsibility, deposit payment, penalty in case of default, and legal treatment. Abdullah and Dusuki (2004) also documented many issues that question the validity of AITAB transaction for instance, intention and lack of understanding of parties, signing of two separate documents in sequence, and interest-based calculation of profit. Sale and ijara contract are the most desirable contracts and 100% *Shari'ah* complaint (i.e., there are many verses in the Quraan & hadith) among all Islamic transactions. But the both contracts does not fully comply Islamic principles in its real life applications (Hashim et al., 2012). The widening effect of issues regarding AITAB implementation has prompted Islamic scholars to rethink about the mechanism of its current operations to make it 100% *Shari'ah*-compliant. More research is clearly needed to explore all the existing issues concerning Islamic hire purchase financing. To take a step further, this study therefore, investigates the issues that need to be addressed to resolve the existing ISSUES in Islamic hire purchase implementation. This study then explores the prospects of AITAB in Malaysia. Lastly, this study provides several recommendations for further improvement of the Islamic hire purchase implementation.

Our findings based on literature review suggest number of significant issues that currently affecting the acceptance of AITAB transaction such as *Shari'ah* framework, ownership,

transfer of ownership, maintenance responsibility, insurance responsibility, deposit payment, penalty in case of default, and legal treatment, intention and lack of understanding of parties, signing of two separate documents in sequence, and interest-based calculation of profit. The findings also show that there is enormous prospect of AITAB in Malaysia due to its strong public acceptance, competitiveness, religious inclination, and others.

The remainder of this paper is organized as follows. In the second section a review of literature related to AITAB, issues and prospects is presented. The findings and discussion are presented in the third section. The recommendations, conclusion, and future research direction are presented in forth section.

A Review of the Literature

Islamic Hire Purchase (AITAB)

Literally, Al-Ijarah Thumma Al-Bai' (AITAB) means to lease, hire, or rent ending with purchase (Khir, 2008). Researcher Jalil (2013) has given simplest explanation about AITAB which is 'hire goods and then purchase'. ISRA (2012) have defined AITAB or Islamic Hire Purchase is an Islamic vehicle financing feature, which is based on two combination of Shari'ah concepts, Ijarah (leasing) and bay' (sale). AITAB was first implemented by Bank Islam Malaysia Berhad in 1995 (Abdullah and Dusuki, 2004). Almost all of the Islamic banks in Malaysia are using AITAB for buying motor vehicles. But the mechanism of AITAB does not comply 100% Shari'ah principles. As researchers Abdulla & Dusuki (2012) have explained the mechanism of AITAB financing in Malaysia: (i) the client for AITAB financing usually identifies a car dealer and selects the car that he needs, (ii) the customer will approach the bank for the car financing and make an agreement to purchase the car after the bank has purchased the car from the car dealer, (iii) the bank purchases the car from the dealer, and hence retains ownership of the car while the car is leased to the client for a specified period of time, (iv) upon having the ownership of the vehicle, the bank and the customers will enter the Ijarah or lease agreement, and (vi) at the end of leasing tenure, both will enter a second contract in which the car will be sold to the same client at agreed price (ISRA, 2012; El-Din & Abdullah, 2007). AITAB has no specific law and its application is based on the conventional Hire Purchase Act 1967. As Chong (2009) noted that conventional and Islamic hire purchase are not significantly different. However, Ayub (2007) has documented that Islamic finance experts believe Ijarah has endless potential as an alternative to interest based financing in respect of evolving a Shari'ah-compliant financial system.

Issues in the Implementation of Islamic Hire Purchase

Dual banking system of Malaysia creates competitive environment where an innovative product like AITAB provides advantages for banks. Therefore, it should be closely monitored to ensure its legitimacy (El-Din & Abdullah, 2007). Currently AITAB is having several issues regarding its operation (i.e., Lacking in Shari'ah framework, ownership and transfer of ownership, maintenance and insurance responsibility, deposit payment, penalty in case of default, legal treatment, intention and lack of understanding of parties, signing of two separate documents in sequence, and interest-based calculation of profit).

Lacking in Shari'ah Framework

The major problem in implementing AITAB in Malaysia is lacking of sharia framework (El Din and Abdullah, 2007). Hanudin Amin (2010) described *Shari'ah* as the “centerpiece and backbone of the religion of Islam”. AITAB financing is named according to Arabic word in order to show that the transaction is based on the Islamic principles. In reality, AITAB legislations are based on the Hire-Purchase Act 1967. The difference between AITAB financing and conventional hire purchase financing is that AITAB financing has an additional agreement which is the sale contract after the leasing period is over. Shiyuti et al. (2012) have further noted that AITAB is growing under the shadow of Hire Purchase Act with some changes to suit the Shari'ah compliant syndrome. This study also agreed by Hassan et al. (2012) that AITAB does not have a Shari'ah compliance to govern it rather it is determined by the conventional legislation. Moreover, AITAB financing has element of interest in calculation of term charges (Hassan et al., 2012). The above facts are in line with our findings from Central Bank Shari'ah Resolutions (Shari'ah Resolutions, 2010).

Ownership and Ownership transfer

According to Shari'ah principles, the bank must own the asset before rent it out because it shows the rights and liabilities of the parties involved in the hire-purchase contract (El Din and Abdullah, 2007). However, Islamic hire purchase contract in Malaysia differs slightly, bank becomes beneficial owner of the asset (usually a motor vehicle), while the customer becomes the legal owner. As researcher Davies (1995) has noted that the banks usually register its ownership claim over the title of the asset and have it endorsed on the registration card which similar to the conventional hire purchase financing. As El Din and Abdullah (2007) agreed that the Islamic hire purchase practice is slightly modified version of the conventional hire purchase. The authors also claimed that if customer and bank officer in charge do not understand the intention and the two different aspects in both lease and sale transactions then, there will be virtually no difference regarding asset ownership between AITAB financing and conventional hire purchase financing (Al-Nashmi, 2003; Syariah Advisory Board, 2002; El Din and Abdullah, 2007). In Malaysia, the common practice is that the transfer of ownership is affected by sale, the asset is purchased through final payment or last instalment which is considered as purchase price. But it generates an issue of whether bank and customer understand that they are completing a sale contract with the customer final payment, if not then the sale contract may not be valid.

Maintenance & insurance responsibility

In the real practice of leasing, the bank has to be responsible with the maintenance of the hired goods but the current practice of AITAB financing in Malaysia shows that the customer is solely responsible with the maintenance while the bank only act as a financier. This action does not explain any responsibility by the bank to the asset being leased and to be purchased by the customer (El Din and Abdullah, 2007). In some cases, both parties have to be liable with the maintenance. For example of leasing a house, the owner should responsible with the maintenance of the house that is not caused by the negligence of the lessee. If the lessee is the one who causes the problem with the leased asset, he should be responsible for the

maintenance. Furthermore, the general principle says that insurance coverage or takaful of an asset is the responsibility of the owner (El Din and Abdullah, 2007). In reality, the insurance or takaful bears by the hirer like in purchasing vehicle. Some Malaysian experts said that risks and liabilities can be transferred to the hirer (El Din and Abdullah, 2007). Shari'ah Legal Opinions (Fatawa Shar'iyyah) of the Kuwait Finance House Malaysia Berhad confirms that it is lawful to make the hirer responsible for insurance, if the amount is known, because it may then become a part of the lease payment (Delorenzo, 2000).

Issues and Prospects of Aitab

Deposit payment and penalty in case of default

Deposit payment is common for business transactions to booked or acquire new asset. It serves as security for the owner in case of loss or misconduct by the hirer. AAOFII Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek (2000) regards deposit made by the hirer as security against loss of a leased asset caused by the misuse or negligence of the hirer. In Malaysia, the minimum deposit payment is 10% from the amount of the asset. Deposit payment is accepted by all customers because it is considered as part of the payment and which entitle to pay less monthly installment. However, in Islamic transactions, the intention and purpose of the payment must be made clearer, particularly to the customer in order to ensure that he or she fully understands the purpose of the deposit payment and the function it serves (El Din and Abdullah, 2007). The valid contract must be mutually agreed by the contracting parties. Any act of default by one of the party will lead to breach of contract. El Din and Abdullah (2007) have cited from (Baharum, 2004) that breaking any of these terms cause the innocent party to suffer a loss that needs to be remunerated. The authors also cited from Hairetdinov (1998) that banks can charge penalty to the customer for delayed payment but it cannot be taken as a source of income for the bank. AAOFII Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek (2000) indicated that hirer who delay the payment without a valid reason have to donate certain amount or rental's percentages to the charity under the coordination of the Institution's Shari'ah supervisory board.

Intention and lack of understanding of both parties

Abdullah and Dusuki (2006) in their research found that most of the customers of Islamic banks or other banks are not aware that they are using AITAB financing in their motor vehicles financing scheme. In addition, researchers Ahmad and Haron (2002) have documented that Islamic banking products and services are little known to the customers. One of the issues is customers' attitude itself. The attitude of the customer towards the product makes it difficult to offer the product to them. Customers do not really understand the basic differences between AITAB financing and conventional hire purchase facility. This is mainly due to the perception that AITAB financing looks same with conventional hire purchase in terms of their operation, documentations and legal prescription. Customer do not really appreciate the distinction of AITAB as a Shari'ah compliant product and also do not care in what way it would provide them with a better scheme and prospect. Some people believe that AITAB is used to avoid *Riba* (interest) while some people think banks are using

Islamic terms to show that AITAB financing is an Islamic financing product but in real life it is just a carbon copy of conventional hire purchase financing.

In addition, the lack of experience and knowledge of bank officers also lead to have a misleading view of the true value of AITAB among the customer. Some of the officers do not have clear idea what is the major distinction between AITAB financing and the conventional hire purchase financing. Apparently, many claim that both conventional and Islamic hire purchase facility share the same characteristic particularly in regards to its documents, procedures and governance. Furthermore, according to Abdullah & dusuki (2007), terms and condition in AITAB agreement are designed by lawyers on the basis of hire purchase act 1967 and principals of contract law, except for some modification made to this document to comply with Shari'ah requirements. Besides, the documentations of AITAB seems to be a lot more complicated than the conventional facility as it involves lot of additional documents to be read and signed. AITAB financing involves two separate contracts whereas conventional hire purchase financing only have one contract. To some extent, the bulky documents of AITAB financing made customers and agents not to choose AITAB financing because the process it takes to complete the document is longer than conventional hire purchase. Financial Institution itself is contributing to the problem in the operation of AITAB in Malaysia. Survey done by Zainol and Shaari (2008) stated that the employees of Financial Institution in Malaysia have very limited knowledge of the fundamental aspects of Islamic banking products. Most of them are not even aware of the objectives of the establishment of Islamic banks.

Thus, to solve this issues, financial institution is recommended to educate their employees on Sharia legislations. This is to ensure that the employees have a strong knowledge on the issues related to the Sharia legislation to handle their customers and to perform their duties. These issues are important as Zainol and Shaari (2008) suggested that the financial institutions' management should take greater initiative in providing sufficient knowledge to their employees to have exposure about the Sharia principles of Islamic banking and financing industry. Further to that, Schneider and Bowen (1985) stated that when the organization furnishes its employees with necessary resources, including logistic, administrative, equipment, and management support, the employees are likely to deliver excellent services to customers. Similarly, Zeithaml (2000) also confirms this by mentioned, "Satisfied employees make customers satisfied (and a satisfied customer can, in turn, reinforce employees' sense of satisfaction in their jobs)." Accordingly, by increasing the understanding of the employees towards the fundamental aspects of Islamic banking products, will later results in higher satisfaction in customer. This is because the customer will have a better confidence in Financial Institutions, which gives them a better understanding of Sharia legislation.

Future Prospects of AITAB Financing

AITAB in Malaysia has a very bright future due to several factors such as strong public acceptance, Muslim majority and others. This section discusses three prospects that can make AITAB better than current position. There are three main factors such as strong public

acceptance, competitiveness, and religious inclination that contribute to make a better prospect for AITAB in Malaysia.

Strong public acceptance

AITAB financing is widely accepted by the customers in Malaysia because it serves better features compared to conventional hire-purchase. Since AITAB is using two separate contract in AITAB financing, customers has a choice either to buy the goods or not to buy when the leasing period is over. Muslims who are concern about interest and uncertainty will undoubtedly choose AITAB financing as their mode of vehicle financing. Non-Muslim on the other hand are choosing AITAB financing because it imposes as low as 1% of penalty in case of late payment while the conventional hire purchase imposes as high as 7%. Customers who understand AITAB operation and found it as an alternative to conventional hire-purchase which provides them better features than conventional hire purchase usually take it as their mode of vehicle financing regardless of their religion. For example, many corporate customers come to Bank Pembangunan to purchase machinery through AITAB facility due to its benefits, for example, full margin of financing and lower penalty for late payment (Abdullah and Dusuki, 2004). Trading companies like Courts Mammoth, Tesco, Carrefour, moneylender and others also adopt hire-purchase concept in their businesses (Abdullah and Dusuki, 2004). Due to the technological advancement, customers can easily search for the best features offered for any product which helps comparatively better features products to gain more market share. AITAB is such a financing product in Malaysia that managed to have greater acceptance among other vehicle financing products due to its comparative advantages.

Competitiveness

AITAB financing became a strong competitor of conventional hire purchase due to its lucrative features. It can be operated by all and thus should not be limited to financial institutions only. AITAB can be benefited from many rules provided in Hire-Purchase Act 1967 which is not contradictory with Shari'ah principles and create a better position compare to the conventional hire-purchase. Customers have a choice either to use a fixed or floating rate in the transaction. AITAB also gives protection for customers and guarantors and clear procedure of ownership. There are many other factorss that can attract prospective customers to use AITAB financing are its Shari'ah compliant characteristics like prohibition of interest and very minimal late penalty charges. Some banks realized that AITAB has a bright future in its operation. Therefore, they are offering AITAB financing in most of their branches to attract more customers. Banks are taking initiatives to widen the scope of AITAB financing in order to include non-national cars which has started in December 2003 (Abdullah and Dusuki, 2004). Central Bank's commitment towards the Islamic product has led to its rapid growth in the market. According to, Abdullah and Dusuki (2004) in regards to the Central Bank's direction, every financial institution in Malaysia must have a total Islamic loan base at 10% by 2005; and at 20% by 2010. In order to comply with the direction, financial institutions have no other mean except to fully mobilize their Islamic products, the most practical one is AITAB financing. The positive views of Malaysian government about

Islamic hire purchase financing will make it more competitive in future. Hence, there is an endless prospect of AITAB financing in Malaysia. Besides, Malaysia is one of the Asian country where numbers of motor vehicles are increasing rapidly and most of them are under financing scheme. This trend also indicates the prospect of AITAB in Malaysia.

Religious inclination

Hire-Purchase Act (1967) is the governing law for both Islamic and conventional hire-purchase financing in Malaysia. The majority of the Muslims in Malaysia prefer a separate Islamic Hire Purchase Act (IHPA) for the Muslims. Furthermore, many academic scholars such as Abdullah (2009) prefers a separate Islamic Hire Purchase Law instead of amending the existing HPA by incorporating in some the Shari'ah principles, because the amendment to the HPA 1967 still would not meet all the Shari'ah requirements. Thus, AITAB needs to have its own governing law to make it different from the conventional hire purchase. AITAB can still be used the similar rules as HPA but it has to be more Islamize in order to avoid confusion among customers. The judges, lawyers and the Shari'ah enforcement authority must have sufficient Shari'ah knowledge regarding AITAB financing if the Shari'ah court wants to implement the Islamic Hire Purchase Act. If Islamic financial institutes can come up with separate Islamic hire purchase act and a platform to facilitate 100% Shari'ah compliant AITAB financing then there will be an endless prospect for AITAB financing in future since majority of the Muslim customers demand pure Islamic hire purchase financing. Besides, pure AITAB financing will abolish many misconceptions about the Islamic financing product which will create a better future for AITAB financing not only in Malaysia but also other parts of the world. Malaysia is a country where majority of them are Muslim but many of them do not use Islamic hire purchase financing due to its contradiction with Shari'ah principles. Thus, the purification of the current practice of AITAB financing will help financial institutions to capture more customers.

Methodology

Descriptive and analytical research method had been applied in this study to analyze the collected secondary data (i.e., Journal articles, books, websites, and contracts acts). This study tries to find out the issues and prospects of implementing AITAB financing in Malaysia. Since the popularity of this Islamic product is increasing, this research will provide a better and more legitimate structured AITAB in financial institutions.

Findings and discussion

The literature review and above discussion provide few ideas: (a) AITAB is a very popular hire purchase contract in Malaysia and it involves many issues that need to be addressed, (b) despite of its limitations, individuals still prefer to use Islamic hire purchase to purchase assets (i.e., motor vehicle), and (c) AITAB has endless prospect in Malaysia due to its competitive advantage compare to conventional hire purchase. Prior studies have discussed many issues that question the validity of the AITAB transaction. For instance, some studies found that it is simply a carbon copy of the conventional hire purchase as it follows the Hire Purchase Act 1967. This issue has also created a misunderstanding among customers about

the differences between AITAB and conventional hire purchase. Besides, there are some differences in understanding AITAB among Malaysian banks, some defined it as financing and some defined it as loan facility. For example, Maybank defined as loan while Bank Muamalat denoted as financing.

Our findings point out the limitations of AITAB implementation such as lacking in Shari'ah framework, ownership and ownership transfer, maintenance and insurance responsibility, deposit payment, penalty in case of default, intention and lack of understanding of parties, signing of two separate documents in sequence, and interest-based calculation of profit. This study also agreed by Hassan et al. (2012) that AITAB does not have a Shari'ah compliance to govern it rather it is determined by the conventional legislation. Moreover, AITAB transaction has interest element in calculation of term charges (Hassan et al., 2012). This study finds that in Islamic hire purchase contract, bank becomes beneficial owner of the asset (usually a motor vehicle), while the customer becomes the legal owner which is contradictory with the Shari'ah principles. As El Din and Abdullah (2007) agreed that the Islamic hire purchase practice is slightly modified version of the conventional hire purchase. According to researchers Abdullah and Dusuki (2006) most of the customers of Islamic banks are uncertain that they are using AITAB transaction in the car financing arrangement. In addition, researchers Ahmad and Haron (2002) have documented that Islamic banking products and services are little known to the customers. Thus, to solve this, Financial Institution is recommended to educate their employees on Sharia legislations. This is to ensure that the employees have a strong knowledge on the issues related to the Sharia legislation to handle their customers and to perform their duties. This issue is important as Zainol and Shaari (2008) suggested that the financial institutions' management take greater initiative in providing their employees with sufficient knowledge of and exposure to rules of the Sharia and the principles governing Islamic banking in particular.

The findings also indicate the endless prospect of AITAB in Malaysia due to its strong public acceptance, competitiveness, and religious inclination. Muslims who are concern about interest and uncertainty will undoubtedly choose AITAB as their choice of financing. Non-Muslim in the other hand are choosing AITAB because it imposes as low as 1% of penalty in case of late payment but the conventional hire purchase imposes higher penalty. For instance, many corporate customers come to Bank Pembangunan to purchase machinery through AITAB facility, because they know the benefits that the facility has to offer, for example, full margin of financing and lower penalty for late payment (Abdullah and Dusuki, 2004). Apart from being utilized by banks, trading company like Courts Mammoth, Tesco, Carrefour, moneylender and others also adopt hire-purchase concept in their businesses (Abdullah and Dusuki, 2004). Due to the above demands of AITAB, it is necessary to solve the existing issues of Islamic hire purchase. It is hoped that issues pertaining to Islamic hire purchase can be resolved through having Shari'ah regulation. Hence, efforts should be strengthened to offer practicable solutions to help provide better and more legitimate structured implementation of Islamic hire purchase in financial institutions.

Conclusion

The discussion above shows that Islamic hire purchase has some strengths and limitations. However, AITAB can be one of the most demanding Islamic products in the future for financial institutions because customers are more concerned of the products that benefit them. It is hoped that Bank Negara Malaysia (Central Bank) and its Shari'ah Advisory Council (SAC) will revise the AITAB transaction to support its regulatory framework. In addition, Islamic experts should ensure that the AITAB is implemented purely based on Shari'ah compliance. Pursuant to that, the financial institution should provide proper training to its worker so that they can have better knowledge and understanding about the product.

We hope that AITAB and other Islamic products will be accepted among all the financial institutions globally as it helps to accelerate economic growth of a country. Apart from that, Mu'amalah Hire-Purchase Bill should be implemented to have AITAB facility, which fully complies with Shari'ah principles. The law will be a comprehensive Shari'ah-compliant regulation that works side by side with conventional law if it is successfully be enforced. This will give a progressive influence towards upgrading the position of Shari'ah law and institutions in Malaysia. Besides, by having this law will affect other area of law to come with a Shari'ah alternative as well. Moving forward, great efforts should be intensified to develop a legal structure to control the transaction and resolve potential disputes arising from AITAB transaction. Hence, establishment of Mu'amalah Hire Purchase Bill by the government is proposed in order to ensure the AITAB transaction and its practitioners comply with the Shari'ah principles.

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