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ABSTRACT

The Islamic Economic and banking industry have been trying for the last two decades to extend its outreach to expand its operation business and services in a comparable footing to conventional banking. This paper discusses one of the important hurdles in the growth of Islamic banking which is the use of KIBOR as benchmark for pricing the Islamic banking products. *Muskun* home financing product of BankIslami Pakistan Limited is used in this paper to elaborate the pricing and benchmarking of product, spread between the conventional interest rate and Islamic profit rate as well as the alternative product pricing mechanism to be used by Islamic banks for this product. Details of *Muskun* home financing product are discussed in this paper in addition to the marketing strategy, market approach, economic product development, and all other relevant processes.

KEYWORDS: Islamic Economics, KIBOR, Benchmarking, Pricing, Riba based system, Confidence level, Ijarah

INTRODUCTION

This paper investigates the alternative pricing mechanism for the Islamic financial instrument (i.e. Ijarah) that is used for house financing by the Islamic banks. Types of contract, product development, marketing strategy, target market, method used for pricing of the product are also discussed in this paper.

The product chosen for the discussion is paper is from BankIslami Pakistan Limited. Before discussion the product in detail let's have a look of house financing in Pakistan.

The Pakistani housing finance condition has much common with that of many other emerging markets around the world. Despite a large and persistent housing deficit (6 million households), a number of factors such as low income levels, legal property issues, and large informal economy result in scarce demand for mortgage loans. Financial institution's growth in mortgage lending- and the subsequent improvement in terms and conditions which might increase further demand in turn has been hampered by a lack of long term funding, inadequate incentives to lend to lower income households, with most banks performing to concentrate their activity on high income groups and the corporate sector (average loan size is Rs. 2.6 million). Islamic Financial institutions are also participating in the house financing.

Islamic financial products are developed by applying the appropriate Islamic financial contracts to suit the financial needs of the users. The range of Islamic financial products has broadened considerably in recent years in response to the more diverse and differentiated requirements of participants. Islamic financial products have progressed and grown in sophistication, as can be seen from the offering of a wider range of products with various product structures, multiple categories of service providers and a different mix of consumer composition. Islamic banking products have evolved from basic consumer or retail products into a full range of product offerings (e.g. retail, corporate, project financing and long-term bond instruments) under various Islamic contracts. The range of Islamic financial products has diversified to include variable rate-based and equity-based mechanisms as well as hedging instruments, and this has strengthened the risk management capabilities of the Islamic financial institutions. Usually the products used for the home financing by Islamic banks are Ijarah and Diminishing Musharakah.

SCOPE

The paper is based on personal experience as well as on the research. This project paper is limited to the discussion of Islamic home financing product used by BankIslami Pakistan limited.

DETAILS OF THE PRODUCTS

The instrument used for this project paper is BankIslami’s “Muskun Home Financing”. **The MUSKUN Home financing facility is based on the principle of Diminishing Musharakah and Ijarah.** The Diminishing Musharakah transaction is based on Shirkat-ul-Milk where customer and the Bank participate in ownership of a property. The share of the bank is then leased to customer on the basis of Ijarah and is divided into a number of units. It is then agreed that customer will buy the units of the bank periodically, thereby increasing customer’s own share till all the units of the Bank are purchased by customer which will make him/her the sole owner of the property. Till that time, customer pay the Bank rent for its units leased to him. The rent will keep on decreasing as customer’s ownership in the property increases and that of the Bank decreases. This product is used for home purchase, home construction, home renovation and home replacement. This is a consumer type product.

Home Purchase

Financing Tenure	2 to 20 years
Financing Range	Rs. 200K – 10M
Bank Investment Ratio	Maximum up to 80% for salaried / selected SEPs * Maximum up to 70% for Businesspersons/NRPs (* Doctors, Engineers, Architectures, Chartered Accountants)
Prepayment Option available	No Penalty applies after one year. In case Customer applies for purchase of early units or pre-payment within 12 months after disbursement, additional Musharakah Units will be revalued at 5% higher than face value.

Home Construction

Construction Tenure	Maximum 2 Years
Financing Tenure	Minimum 2 Years (excluding construction period) Maximum 20 Years (including construction period)
Financing Range	Rs. 200K – 10M
Bank Investment Ratio	Salaried / Selected SEPs*:

	<ul style="list-style-type: none"> • Up to 80% for financing up to Rs. 10M. • Up to 70% for financing > Rs. 10M. Businessmen/NRPs: Up to 70% for all financing amounts.
Prepayment Option available	No Penalty applies after one year. In case Customer applies for purchase of early units or pre-payment within 12 months after disbursement, additional Musharakah Units will be revalued at 5% higher than face value.

Home Renovation

Construction Tenure	Maximum 6 months
Financing Tenure	2-7 Years
Financing Range	Rs. 150K – 10M
Bank Investment Ratio	Maximum 50% for Salaried / Selected SEPs* Maximum 50% for Businessmen/NRPs (* Doctors, Engineers, Architectures, Chartered Accountants)

Home Replacement

Financing Tenure	2-20 Years
Financing Range	Rs. 200K - 10M
Bank Investment Ratio	Salaried / Selected SEPs*: Up to 80% for all financing Businessmen/NRPs: Up to 70% for all financing amounts. (* Doctors, Engineers, Architectures, Chartered Accountants)
Prepayment Option available	No Penalty applies after one year. In case Customer applies for purchase of early units or pre-payment within 12 months after disbursement, additional Musharakah Units will be revalued at 5% higher than face value.

PRODUCTS INCENTIVES

1. Quick Processing
2. Financing up to 50% of the value of the property
3. Financing limit Rs. 10Million
4. Tenor up to 20 years
5. No pre-payment additional price charged after one year
6. Flexible & Affordable installments with Sahulat payment schedule
7. Clubbing of family income
8. No Negative Area

METHODOLOGY

1. Customer will approach BankIslami and inform about his needs of financing for Home Purchase, Construction, and Renovation or Balance transfer facility.
2. He will then submit the filled Application Form along with the required documents and a cheque for processing fee. BankIslami Business Executive will guide the customer during the whole process.
3. The Bank will conduct verification of customer's residence & office addresses as well as those of the references provided by him.
4. The Bank will then conduct his Income estimation to determine the maximum financing that can be provided to customer. In case Customer is Self Employed, Bank's agent will approach him for the necessary income details and documents. In case Customer is Salaried, Bank will approach his employer for this purpose
5. A legal opinion is then obtained by the Bank on the property documents submitted by the customer
6. Valuation of the property is done to determine its Market value
7. The Bank then issues to customer an **offer letter** for the financing amount he qualified for based on his evaluation.
8. After the acceptance of customer, a Shirkat-ul-Milk (Musharaka) Agreement is signed between him and the Bank, whereby, the Bank and he will become joint owners (partners) in the Musharakah property. A Pay Order is issued in the name of the seller in case of MUSKUN Home purchase by the bank. Bank's Business Executive and our in house / external lawyer will accompany customer for the transfer of property in his name. The Pay Order is then handed over to the seller. In case of MUSKUN Home Construction / Renovation / Replacement Cases, the financing amount is simply credited to customer's account. It is ensured through

- Shariah-compliance checks that the funds are utilized only for construction/renovation/replacement.
9. Customer and the Bank now jointly own the home
 10. Customer and the Bank also execute a **Monthly Payment Agreement** whereby customer agree to pay a monthly payment to the Bank for the use of the bank's ownership in home
 11. Undertaking to Purchase is given by customer, under which he undertake to purchase the Musharakah Units (representing Bank's undivided ownership share in the property) from the Bank periodically.
 12. On monthly basis, customer purchase Musharakah units from the Bank
 13. When customer has purchased all units of Bank, you become the sole owner with a free and clear title to customer's home.

REQUIREMENT AND ELIGIBILITY

Citizenship	Pakistani
Cities	Karachi , Lahore and Islamabad/Rawalpindi
Age Limit	<p>Salaried/Businessmen/Selected Professionals: Primary Applicant: 25-65 Years Co- Applicant: 21-70 Years</p> <p>NRPs: Primary Applicant: 25-60 Years. Co- Applicant: 21-70 Years.</p>
Employment Tenor	<p>Salaried: Minimum 6 months at current employment and 2 years continuous employment experience in the same industry/field.</p> <p>Businessmen: 3 years of business / practice.</p>
Minimum Income	<p>Salaried: Rs. 35,000/- Business man: Rs. 50,000/- NRPs: Rs. 100,000/-</p>
Additional Criteria for NRPs	<ol style="list-style-type: none"> 1. An NRP needs to have a Co-applicant residing in Pakistan as an Authorized Person on behalf of the NRP. 2. Only Salaried NRPs can avail MUSKUN Home Financing.

DOCUMENTATION

Copy of CNIC (Applicant and Co-applicant)
 2 passport size photographs (Applicant and Co-applicant)
 Completely filled Application form with Applicant's Profile Report
 Copies of Last 6 months paid utility bills

Property Documents	For Salaried Persons	For Businessman	For NRP
Copy of chain of all title documents Approved Building plan Public notice	Employment certificate issued by employer Last three Salary Slips Bank Statement of last 12 months Detail of other financing along with its repayment	Income tax return for last three years, Proprietorship Letter/Partnership deed/ Memorandum and Articles of Association Company Bank Statement of last 12 months Detail of other financing along with its repayment Marketing Strategy	We offer NRPs (only salaried segment) purchase/construct/renovate/balance transfer facility of a House/Property only in Pakistan; Last three months Salary Slip Copy of Passport Copy of NICOP VISA/residential status proof Tax deduction details Employment Certificate and Contract Copy Bank Letter and Banks Statement of last 12 months 2 passport-sized colored Photographs of Applicant / Co-Applicant All the above mentioned documents relating to NRP should be duly attested by Pakistani Consulate

PRODUCT DEVELOPMENT

Product development is the process of designing, creating, and marketing an idea or product. The product can either be one that is new to the marketplace or one that is new to the bank, or, an existing product that has been improved. In many instances a product will be labeled new and improved when substantial changes have been made. Product

Development is an important area in which an Islamic Bank needs to focus its resources, for a variety of reasons.

- It enables the bank to retain customer and compete in today's competitive financial services environment.
- Effective Product Development creates synergy between the customers and the bank and thus assists the bank in better understanding the needs of its customers.
- A satisfied customer is often a repeat customer and a great source of referrals.

Product Development is an integral component in the quest to serve the customer. Once the need of the Customer identified Product Development process for proprietary products would comprise of the following steps:

- Planning
- Development
- Initial Approval
- Testing & Modification
- Second Approval
- Implementation
- Finalization
- Final Approval
- Training of the Staff.

According to Athar Khan (2009) the most deficient activity in the entire new product development process for failed projects...

Detailed market study	74%
Test Marketing	58%
Product Launch	54%
Financial/Biz Analysis	52%

1.1. Target Market

The target market for this product mentioned below;

- Salaried individual
- Businessmen
- Corporate and SME

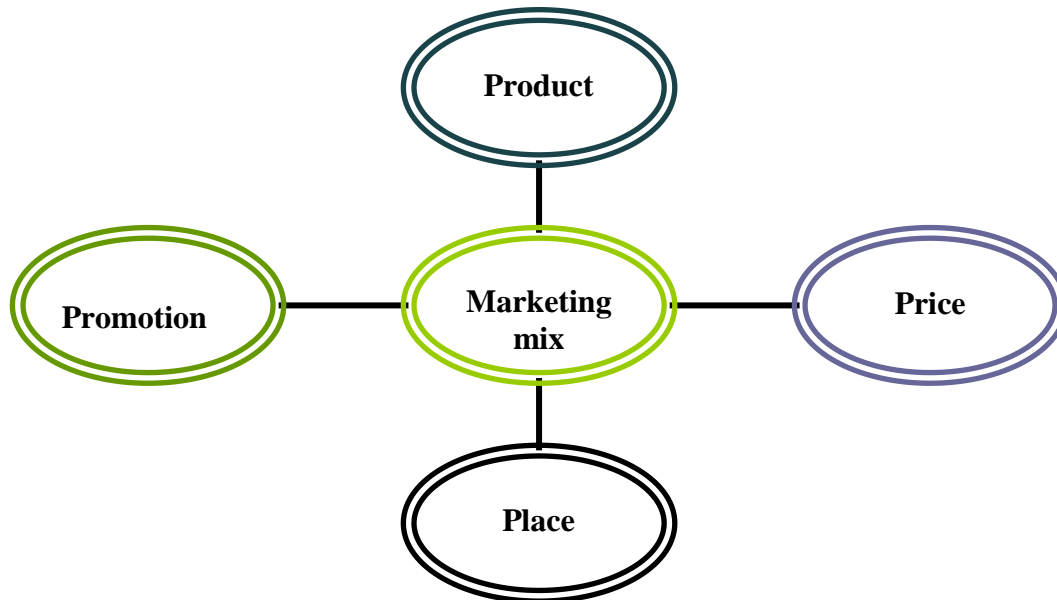
1.2. Distribution Channels

The target market will be accessed via the following distribution channels:

- Direct Acquisition Channels-Branches
- Consumer & Retail Sales Staff
- Alternative Channel such as telemarketing, strategic business partnership and other sales distribution channels to be arranged and determined in the future.

2. Sales and Marketing Strategy

Marketing strategy is a marketing logic by which business unit hopes to achieve its marketing objectives. Using market segmentation, targeting, and positioning, the company decides which customers bank will serve and how.



To find the best marketing strategy, any organization engages in marketing analysis, planning, implementation & control, adapting to forces & other actions in the market.

Targeted to achieve 4 C's as: -

- Customer satisfaction
- Customer cost
- Convenience
- Communication

For communication, print media, banners, emails, Telemarketing, will be done.

According to Haron and Azmi (2005) the top five factors that are considered as important by Malaysian Muslim when selecting their banks are:

1. Fast and efficient services
2. Speed of transactions
3. Friendliness of bank personnel
4. Confidentiality of bank
5. Knowledgeable about the needs of customers

Non-Muslim customers ranked the following as important when selecting their banks:

1. Friendliness of bank personnel
 2. Fast and efficient services
 3. Reputation and image of bank
 4. Speed of transactions
 5. Confidentiality of bank
-
3. Method used in Pricing of Product

Standard pricing formulas, in the light of Shariah principles, are needed for best working of the Islamic financing model across the globe. This development will promote Islamic finance in world with full confidence. Because right now the profit charged by the Islamic banks or the price charged by Islamic banks is based on the Karachi interbank offered rate (KIBOR) or interest rate. The Profit rate used by BankIslami to calculate the monthly rentals is 1 Year KIBOR +3.5 %.

4. Benchmark used for pricing of Product

The pricing technique used by the conventional banks in the country is based on the KIBOR or a flat rate. For example Standard chartered bank in Pakistan charge markup rates for mortgage loan for salaried is 17% and Self-employed is 17.5% per annum.

The benchmark used for this product is basically based on the Interest rate prevailing in the country. BankIslami marking the price of product as 1 year KIBOR + 3.5. One year KIBOR is 13.07% as per the data available on the State Bank of Pakistan. So, if we add 3.5% in 13.07% the total will become 16.6% which is close to the conventional banks pricing as compared to Standard chartered bank which is 17%.

At Meezan Bank of Pakistan (First full fledged Islamic Bank), the profit margin is directly correlated to market trends to provide a competitive product to our customers. Shariah allows the use of any conventional market factor as a benchmark to determine the profit rate of a particular product. The mere fact that the applied profit rate of our product is based on similar factors used in determining the applied rate of interest of a mortgage does not render the transaction or the contract invalid from the Shariah perspective, and neither does it make the transaction an interest-bearing one. On the other hand, it is the underlying structure of the product that determines its Shariah compliance. And all Islamic financial institutions practices are like this.

CONVENTIONAL INTEREST RATE vs. ISLAMIC PROFIT RATE

According to the Quarterly Housing Finance Review (2008), the following trend is present in interest rate for housing finance banks as well as House building Finance Corporation of Pakistan (HBFC).

Figure 1 shows that interest rates on housing loans have remained constant for HBFC and other banks only up until September 2007. Differential interest rates have been witnessed among financial institutions, with HBFC charging an interest rate of 9% (on average) and Banks charging around 12%. According to Figure 1, the quarter December 2007 has seen interests rates converge to 12% for both HBFC & Banks/DFIs. This is in line with the increasing levels of inflation that is feeding into cost of production through increased fuel prices and there by escalating the cost of borrowing and affecting the borrowers' ability to pay scheduled amounts due in the face of abrupt changes.

Figure 1

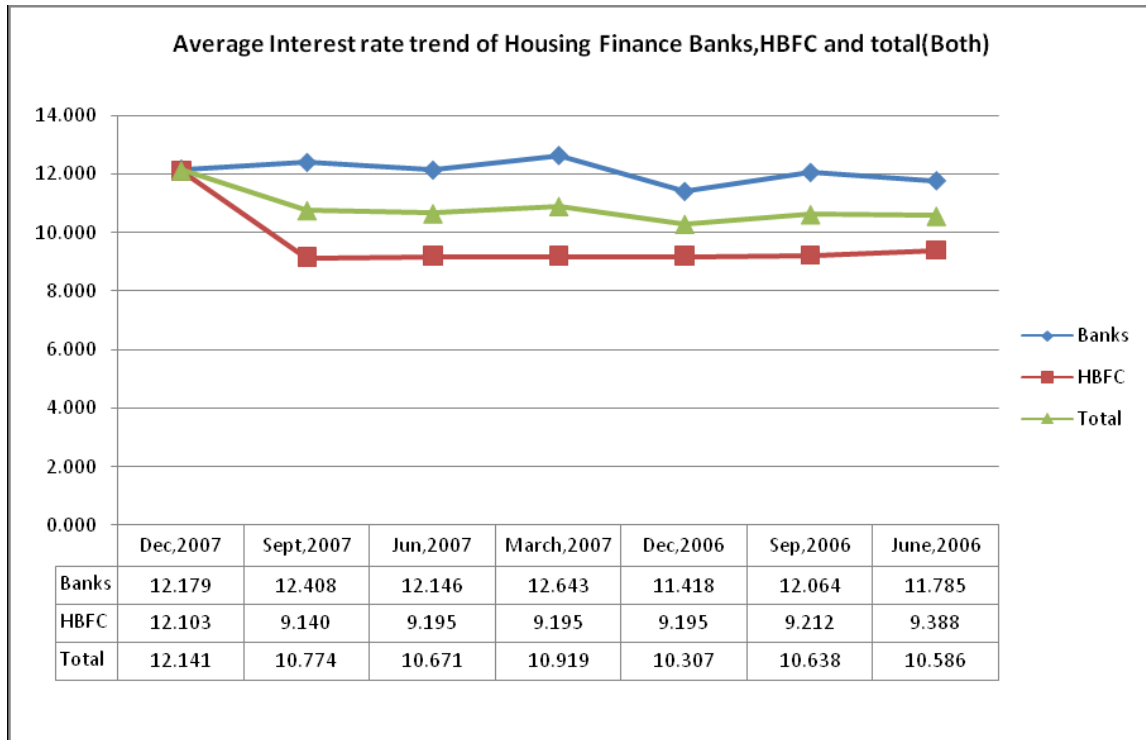
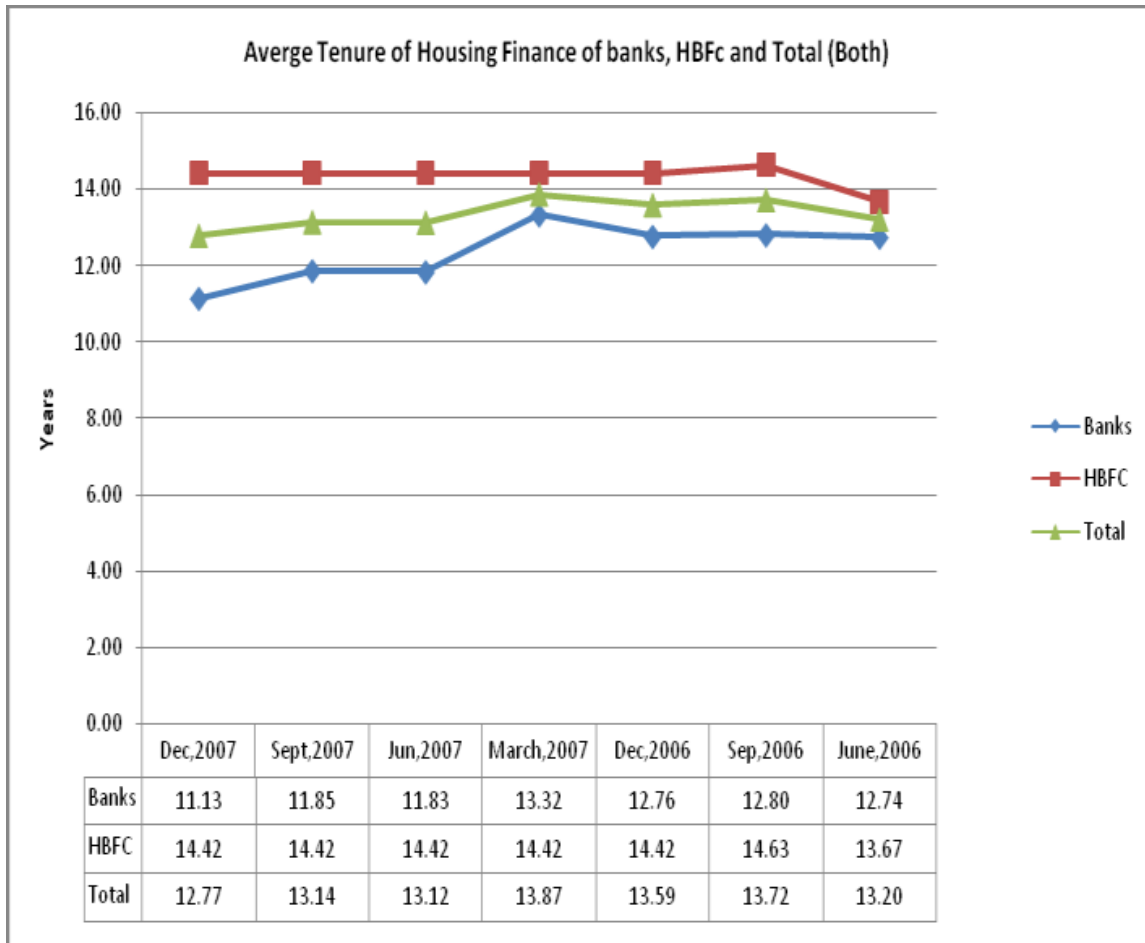


Figure 2 shows that tenure on an average has remained around 13 years with Banks showing a downward trend in their tenure offerings where as HBFC is seen to be lending for 14 years, on an average. This might contribute in increasing the monthly mortgage repayment, borne by the borrower.

Figure 2



In 2007 the average rate of interest charged by the customers from the conventional banks for Housing products like mortgage was around 15% on average. And if we see the pricing of Islamic banks housing product in the same tenure then it is evident that the both conventional as well as Islamic banks are charging similar price.

5. Alternative Product Pricing Mechanism

I suggest that Islamic Banks should not use interest rate as a benchmark for the pricing of their products though they have fatwas for using interest rate as their benchmark for pricing. Rather they should use Hedonic models to value real assets, especially housing, and view the asset as representing a bundle of characteristics, each of which gives either utility or disutility to its consumer¹. Hedonic models are often used to produce appraisals or valuations of properties, given their characteristics (e.g. size of dwelling, number of bedrooms, location, number of bathrooms, etc). In these models, the coefficient estimates represent ‘prices of the characteristics’.

¹ Hedonic model is discussed by Chris Brook in his book “Introductory Econometrics for Finance” 2nd Edition pp-112

One such application of a hedonic pricing model is given by Des Rosiers and Th'erialt (1996), who consider the effect of various amenities on rental values for buildings and apartments in five sub-markets in the Quebec area of Canada. After accounting for the effect of 'contract-specific' features which will affect rental values (such as whether furnishings, lighting, or hot water are included in the rental price), they arrive at a model where the rental value in Canadian dollars per month (the dependent variable) is a function of 9--14 variables (depending on the area under consideration). The paper employs 1990 data for the Quebec City region, and there are 13,378 observations. The 12 explanatory variables are:

- LnAGE log of the apparent age of the property
- NBROOMS number of bedrooms
- AREABYRM area per room (in square meters)
- ELEVATOR a dummy variable = 1 if the building has an elevator; 0 otherwise
- BASEMENT a dummy variable = 1 if the unit is located in a basement; 0 otherwise
- OUTPARK number of outdoor parking spaces
- INDPARK number of indoor parking spaces
- NOLEASE a dummy variable = 1 if the unit has no lease attached to it; 0 otherwise
- LnDISTCBD log of the distance in kilometers to the central business district (CBD)
- SINGLPAR percentage of single parent families in the area where the building stands
- DSHOPCNTR distance in kilometers to the nearest shopping centre
- VACDIFF1 vacancy difference between the building and the census figure

In this way Islamic bank can price their products of home financing based on Ijara and Diminishing Musharakah. The rentals and the price of units to be sold will be easily determined according to the place and area of the house. One more suggestion for this product is to use rental index or housing index. The risk for Ijarah and their mitigating tools are given by below;

Risks	Solution
Repayment/default Risk	Risk can be mitigated by market value of Ijarah asset which may be reposed & collateralized.
Price Risk	It must be ensured that promise to Ijarah is properly documented and legally enforceable.
Residual Value Risk	It is mitigated by the market value of the asset which is reposed.
Early Termination Risk	Mitigated by taking a profit on the sale in case of early termination.
Legal Risk	Proper documentation and timely checking is required.

Source: Handbook of Islamic SME Financing published by State Bank of Pakistan

CONCLUSION

Islamic banks are in serious need of establishing a pricing mechanism for their products other than the interest based rate. Islamic banks had to better understand the needs, preferences, behavior, demand and exact requirement of the customer. Because of the increased competitive market players of Pakistan; people are willing to buy the products of Islamic banks but they have serious concerns as to the pricing methodology. Hedonic Model used in this paper for the alternative pricing model can be very helpful but requires more research and market testing to ensure workability. It is to note that as the competition grows in the Pakistani market, product differentiation and match-to-solution will be the decisive factors to win.

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