

Differentiation Strategy of the Indonesian Islamic Banking Through a Contract Type for Home Financing

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Abstract: Contract type for home financing becomes the differentiation strategy of the Indonesian Islamic banking. The growth of Islamic banks in the last 5 years has shown stagnation; The people have not been able to feel the significant difference in benefits toward the existence of Islamic banks. Similarly, the financial performance of Islamic banks is worse than that of conventional banks. The objective of the research is to select the best Islamic home financing product as a differentiation strategy of Islamic banks in Indonesia. The selected product is expected to accelerate Islamic banking market share, to improve financial performance and to give more benefits to customers. Analytical Network Process (ANP) method was applied to select one of the four Islamic home financing products, i.e., Musharakah Mutanaqisah (MMQ), Ijarah Muntahia Bittamleek (IMBT), murabahah and murabahah hakiki. The results indicate that murabahah hakiki is the best selected product.

Key words: Islamic bank, ANP, Islamic home financing, murabahah, MMQ, IMBT

INTRODUCTION

Indonesian Muslim population has reached 87.21%, however, it is not proportionally to Islamic banking market share in Indonesia which was only 5%. Even in the last 5 years, the Islamic banking growth has been stagnant (Table 1). Moreover, several financial performance indicators indicate that Islamic banking is far behind the conventional one.

To improve the financial performance of Islamic banks as well as to accelerate their growth, Islamic banks in Indonesia should focus on home financing business. Data imply that risk level and financial performance in consumption financing sector, especially, home financing of Islamic banks are relatively equal to conventional banks.

Home financing business segment is a lucrative business sector, since, housing is a primary need for the society. National Socio-Economic Survey (SUSENAS) (Anonymous, 2013) (in the SMF research team) found that the residential ownership in Indonesia only reached 52.2 million out of a total of 65.5 million, indicating that there are about 13.3 million households that do not have their own homes, so, they rent or use other means for their housing. With a population of 252.2 million in 2014 and population growth of 1.34% per year, it is predicted that there will be an increasing demand for housing mortgage facility as the main source of financing for consumers. In 2016, 75.77% people conducted residential property using mortgage using staged cash by 16.82% and direct cash by 7.41% (SMF research team).

Table 1: Asset and market share growth of Islamic banking versus conventional banking

Years	Islamic Banking (IB)	Annual IB growth (%)	Conventional Banking (CB)	Annual (CB) growth (%)	IB market share (%)	IB market share growth (%)
2007	36.538	-	1.986,501	-	1.81	-
2008	49.555	36	2.310,557	16	2.10	16
2009	66.090	33	2.534,106	10	2.54	21
2010	97.519	48	3.008,853	19	3.14	24
2011	145.467	49	3.653,832	21	3.83	22
2012	195.018	34	4.262,587	17	4.37	14
2013	242.276	24	4.954,467	16	4.66	7
2014	272.343	12	5.615,149	13	4.63	-1
2015	296.262	9	6.095,908	9	4.63	0
2016	356.504	20	6.729,799	10	5.03	9

Anonymous (2016)

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Table 2: Financial performance indicators of Islamic bank versus conventional bank

Years	2014		2015		2016	
	Islamic Banking (IB) (%)	Conventional Banking (CB) (%)	Islamic Banking (IB) (%)	Conventional Banking (CB) (%)	Islamic Banking (IB) (%)	Conventional Banking (CB) (%)
Car	15.74	19.57	15.02	21.39	15.95	22.93
Roa	0.41	2.85	0.49	2.32	0.63	2.23
NPF/NPL	4.39	1.37	4.27	1.55	3.73	1.79
FDR/LDR	86.66	89.42	88.03	92.11	85.99	90.79
BOPO	96.97	76.29	97.01	81.49	96.23	82.22
NOM/NIM	0.52	4.23	0.52	5.39	0.68	5.63

CAR (Capital Adequacy Ratio), ROA (Return on Asset), NPF/NPL (Non Performing Financing/Loan), FDR/LDR (Financing/Lending to Deposit Ratio), BOPO (Expense to Income Ratio), NOM/NIM (Net Operating/Interest Margin)

Table 3: NPF performance of Islamic banking based on type of usage and debt group

Types of use and debtor group	2014			2015			2016		
	Volume	NPF	Percentage	Volume	NPF	Percentage	Volume	NPF	Percentage
Working capital	77.935	4.742	6.09	79.949	4.917	6.15	87.363	4.996	5.72
Micro small and medium enterprise	40.205	2.839	7.06	33.382	2.275	6.81	35.827	2.123	5.93
Non micro small and medium enterprise	37.729	1.904	5.05	46.567	2.643	5.68	51.535	2.872	5.57
Invertment	41.718	1.854	4.45	51.690	2.325	4.50	60.042	3.365	5.60
Micro small and medium enterprise	19.600	1.037	5.29	16.909	1.136	6.72	18.703	1.744	9.32
Non micro small and medium enterprise	22.118	818	3.07	34.781	1.189	3.42	41.339	1.622	3.92
Consumption (Non micro small and medium enterprise)	79.677	2.035	2.55	81.357	2.005	2.46	100.602	1.937	1.93
Total financing	199.330	8.632	4.33	212.996	9.248	4.34	248.007	10.298	4.15

Table 4: Home financing comparison of NPF/NPL of Islamic banks versus conventional banks

Period	Type of bank	Outstanding (in million)	NPF/NPL (in million)	Ratio NPF/NPL (%)
Jun-14	Conventional bank	307.872,960	7.152,547	2.32
	Islamic commercial bank	34.682,047	968.374	2.79
Dec-14	Conventional bank	316.422,786	6.489,145	2.05
	Islamic commercial bank	25.698,492	838.871	3.26
Jun-15	Conventional bank	325.677,269	8.214,109	2.52
	Islamic commercial bank	27.145,829	928.858	3.42
Dec-15	Conventional bank	338.428,167	7.732,360	2.28
	Islamic commercial bank	27.496,206	826.491	3.01
Jun-16	Conventional bank	351.538,300	9.328,771	2.65
	Islamic commercial bank	28.180,786	795.796	2.82
Dec-16	Conventional bank	364.196,478	9.264,640	2.54
	Islamic commercial bank	29.794,521	755.573	2.54

Islamic business unit data aggregated in its parent conventional bank; Anonymous (2016)

Based on the above potential, it is necessary to set a strategy to select mortgage products based on Sharia principles as a mainstay product for Islamic banking in Indonesia to accelerate its growth as well as to improve its financial performance (Table 2-4).

Literature review: Islamic home financing is conducted by transferring ownership of a house from the seller to the bank. After the bank has full rights on the house, they will provide financing with alternative types of contracts including murabahah, IMBT and MMQ. In general, people perceive that mortgage from the Islamic banks is relatively more expensive than that of the conventional ones. Home financing products in

Indonesian Islamic banks are quite varied in accordance with their respective contracts. Murabahah is known as the most popular contract. According to Anonymous (2000), Islamic banks are encouraged to provide murabahah facilities for those who need, i.e., selling an item by asserting its fixed price to the buyer and the buyer pays the additional price as profit. Aris *et al.* (2012) explained that BBA al-Bay Bithaman Ajil uses the concept of murabahah that is the price is added by profit (cost-plus) and then is resold by the bank to the customer with deferred payment. Thus, the repayment will remain during the contract period.

According to Meera and Abdulrazzak (2009), the murabahah scheme (BBA = al-Bay Bithaman Ajil) which

is widely practiced in Malaysia, Indonesia and Brunei has weaknesses in the short term when an early paid off or default occurs. The customers will pay more than conventional mortgage credit schemes.

In this case, there are two different schemes in murabahah known in Indonesia due to the different ownership process undertaken by Islamic banks. The first scheme is a regular murabahah in which the bank acts as a buyer of an asset owned by the housing developer and sells it to the customer with a margin. The second scheme is murabahah hakiki in which the bank acts a buyer of the land and builds a house and then sells it. There is inventory risk attached in the scheme but the bank also obtains other compensation in the form of thicker margins. This scheme allows bank to provide cheaper house price by reducing the thicker margin, so that, customers will receive competitive prices (lower installment mortgage) (Fig. 1-3).

Budi (2009) stated that factors affecting small housing type demand in Semarang include house price, consumer income, mortgage interest rate, housing rental rate and distance to central business area. The most significant

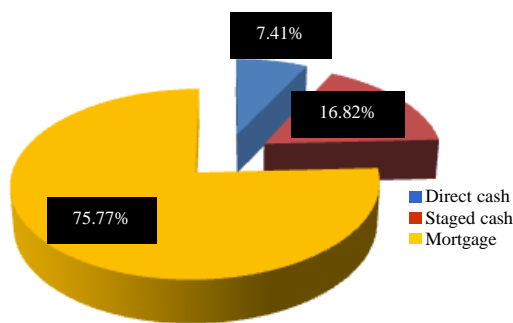


Fig. 1: Financing source for customers

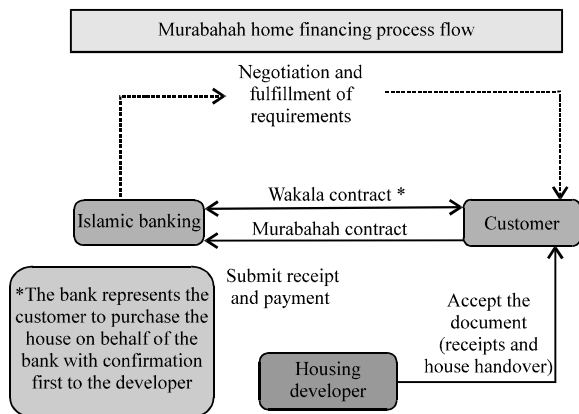


Fig. 2: Murabahah home financing process flow

factor is the price with demand elasticity of -4.2% which indicates that every 1% of decreasing house prices will increase potential demand of 4.2%. Ramadhan and Hesna (2014) stated that selling small type of houses is more profitable than selling medium and big types of houses.

Another financing product scheme is IMBT (Al-Ijarah al-Muntahiyah bi al-Tamlik), i.e., a lease agreement accompanied by the option of transferring ownership of the leased item, to the lessee, upon completion of the lease period (Anonymous, 2002). The third contract is Musyarakah Mutanaqisah (MMQ). MMQ is a contract formed by the cooperation between bank and house buyer by sharing the right of house ownership. The monthly payments by the house buyer will be followed by transferring the right of house ownership in accordance with the paid proportion. Thus, MMQ is called a contract with the concept of diminishing partnership (Fig. 4 and 5).

Khan and Ahmed (2001) stated that risk perception in various financing models in Islamic banks that include credit risk, mark-up risk, liquidity risk and operational risk put murabahah contract at the lowest risk level compared to other contracts such as mudharabah, musyarakah, ijarah, istishna, salam and diminishing musharaka. At credit risk between 1 and 5, murabahah contract has the

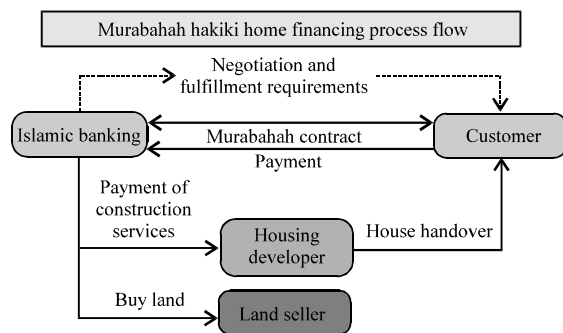


Fig. 3: Murabahah hakiki home financing process flow

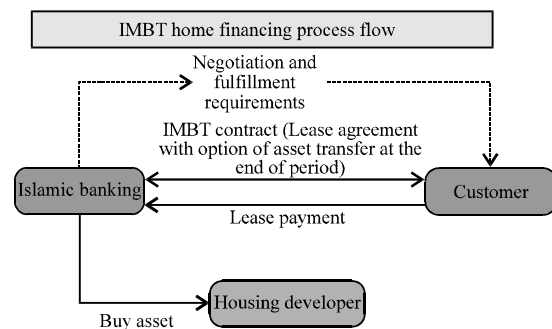


Fig. 4: IMBT home financing process flow

Table 5: Illustration of varied scheme/contract

Contract types	Structure	Financing types
Murabahah	The "Costplus" method. The selling price of the bank consists of the cost of the principal plus the profit and the customer pays the installment for a certain period	Debt type financing
Murabahah hakiki	The "Costplus" method. The selling price of the bank consists of the cost of the principal plus the profit and the customer pays the installment for a certain period. Banks also act on home providers	Debt type financing+trading
(MMQ)	Bank and customer agree to deposite capital in accordance with the portion as agreed. The bank leases the asset to the customer and the customer pays the rental fee during agreed period. Payments made by the customer will gradually reduce the portion of assets owned by the bank so that nil at the end of the maturity	A joint ownership
IMBT	The bank buys the assets for lease to the customer and the customer pays the rent during the agreed period with the promise (wa'ad) there will be ownership transfer option at the end of the lease period	Lease asset

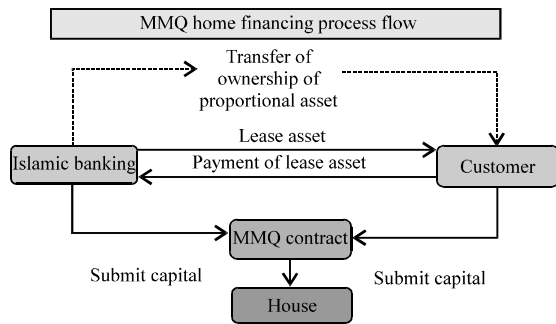


Fig. 5: MMQ home financing process flow

lowest risk level at 2.56 followed by ijarah at 2.64. Similarly, the mark-up risk and operational risk has the smallest risk levels at 2.87 and 2.93, respectively (Table 5 and 6).

According to Usman and Yusof (2015) the result of the assessment of the dynamic relationship between macroeconomic variables (GDP, house price, stock prices and interest rates) and home financing provided by Islamic banks in Malaysia showed that the short and long term policies stimulating home financing focused only on GDP, home prices and monetary policy. Simultaneously, it affirmed the relationship between the real sectors of the economy and the financing of Islamic banks in Malaysia. The result also indicated that at least in the short term, home financing of Islamic banks in Malaysia did not depend on the interest rate which means Islamic bank can use rental rate as a reference rather than conventional bank interest rate, so that, the banks can realize the purpose of its maqasid Sharia promoting the real sector to increase Islamic home financing.

Amin (2008) found some variables that determine the selection of Islamic financing in Labuan Malaysia. The variables consist of (the order of the most important) Sharia principles, lower repayments, openness, interest free practices and no down payment as the most important factors. Other influential factors, considered to be less important include the longer payment period,

Table 6: Risk perception index

Variables	Credit risk	Mark-up risk	Liquidity risk	Operational risk
Murabahah	2.56 (16)	2.87 (15)	2.67 (15)	2.93 (14)
Mudarahah	3.25 (12)	3.0 (11)	2.46 (13)	3.08 (12)
Musharakah	3.69 (13)	3.4 (10)	2.92 (12)	3.18 (11)
Ijarah	2.64 (14)	2.92 (12)	3.1 (10)	2.9 (10)
Istisna	3.13 (8)	3.57 (7)	3.0 (6)	3.29 (7)
Salam	3.20 (5)	3.50 (4)	3.20 (5)	3.25 (4)
Diminishing musharakah	3.33 (6)	3.4 (5)	3.33 (6)	3.4 (5)

The numbers in parentheses indicates the number of respondents. *The rank has a scale of 1-5 with 1 indicating "Not serious" and 5 denoting "Critically serious"; Khan and Ahmad (2001)

product variation and branch location. Doraisamy, Shanmugam and Raman stated that public had an awareness of Islamic banking products and services at a certain level and the main reason is the level of profitability and service quality. Another fact found shows that most people do not use Islamic banks.

MATERIALS AND METHODS

Stage 1 construction of ANP model: This study applied ANP method whose structure consists of four actors of home financing industry (as clusters). The actors are bank, housing developer, customer and regulator; the four factors have each criterion to determine the choice of products that are considered strategic and have differentiation value of Islamic banks, so that, the selected products will be recommended to be "Flagship" products. The clusters and criteria are presented as follows (Table 7).

Stage 2 quantification model: Expert respondents consist of 7 respondents. They are Sharia Supervisory Board of Islamic Bank, Head of Sharia Department of Bogor Agriculture University (IPB), General Manager of Banking Risk Management and General Manager of Banking Consumer Financing (both from BNIS; One of the 3th largest Islamic bank in Indonesia), Sharia Economic Community (representative of customer), Financial Service

Table 7: ANP Model

Clusters/Nodes	Definition
Bank	
Bank reputation	The reputation of Islamic banks as agent of real sector business unlike other financial institutions which invest on derivative financial instruments. Home financing is real sector, the selection of Islamic banks appears to be predominantly a combination of Islamic and financial reputation and quality service offered by the bank
Risk managemnt	Risk managemnt by the bank is adjusted to the type of contract such as IMBT, MMQ, murabahah and murabahah hakiki, especially, market risk, operational risk, credit risk and reputation. Murabaha contract has the lowest risk perception (Khan and Ahmad, 2011)
Market share growth	Products with the highest growth differentiation value are considered to have best opportunity to increase Islamic bank market share
Human capital competency	Employees competencies of Islamic competency banks in conducting operational product such as Murabahah, IMBT, MMQ, murabahah hakiki perofessionally. In the table, "Patronage study on Islamic baning" by various literatures mentioned that one of the important criteria in the selection of Islamic banks is "Competence and courtesy of bank's staff"
Third party deposan	Third party funds increased due to dopsan financing of home financing transaction
Profitability	The profit obtained by Islamic banks because of product features owned by murabahah, IMBT, MMQ, murabahah hakiki effect the growth consumer demand on Sharia home financing
House developer	
Business risk reduction	The risk of unsold house is no risk longer borne by the housing developer but becomes inventory for the bank
Business expansion potential	Better cash flow for housing developers because it is not contained in the farm of inventory
Potential of income declining	The margin on the selling the house no loner acquirad by housing developers but repelaced by fee (ujrah) from Islamic Bank for its services to build house
Customer	
Competitive price	The Sharia mortgage installment is competitive compared to conventional because of the potential declining in house prices offered by Islamic banks. Cost and benefit is one of the selection criteria considered by the customer
Service	Fast and ease of transaction, excellence including document clarity and HR skills in serving consumers mentioned service delivery as "Provision of fast and efficient services"
Sharia principles	Type of contract totally in principles accordance with sharia principles. Stat religious factor as one of the selection criteria that determine the bank
Regulator	
Insider trading	The potential of Islamic banks trading violates its function as intermediary and acts as a trader for un-built land
High risk of banking business	Business risk base on each type of contract not only credit risk but business also operational risk, market risk and reputational risk
Risk inventory	Liquidity risk absorb by Islamic banks due to the presence of inventory

Authority (OJK) as representative of regulator and Housing Developer. ANP questionnaire is pair wise comparisons between elements (nodes) of the clusters to find out which one is the greatest and has differences in numerical scales between 1 and 9. Data collected were put into super decision software to be processed to produce output in the form of priority.

Stage 3 syntheses and analysis based on geometric mean and rater agreement: Geometric mean was used to determine the results of individual assessment of the respondents who determined the results of opinion in a group. The questions of comparison (pair wise comparison) of the respondents were combined to form a consensus:

$$U = \sqrt[n]{X_1 \cdot X_2 \cdot X_3 \cdot \dots \cdot X_n}$$

Where:

U = Geometric mean

n = Total respondent

X₁-X_n = Value

Rater agreement is a measurement that indicates the level of respondent's agreement (R1-Rn) to a problem in a cluster. The common tool used in the rater agreement is Kendall's coefficient of concordance (W; 0<W•1). W = 1, indicating perfect conformity (Awaludin, 2016).

RESULTS AND DISCUSSION

Indonesian Islamic bank market growth shows stagnation in last 5 years. Several issues which were considered to be the cause include the financial performance of Indonesia Islamic banks which is worse than that of conventional banks (Table 2). Also, people have not been able to feel the significant difference in the benefits the existence of Islamic banks. To solve issue in Islamic banks, they should establish a differentiation strategy involving several parties. The research involves 4 correlated parties; i.e., banks, house developer, customer and OJK as regulator and policy holder.

The most influencing actor determined differentiation strategy: Based on the figure, the differentiation strategy of Indonesia Islamic banking for home financing is more determined by the bank with the highest geometric mean (μ) value at 0.4358, followed by house developer (0.2286), customer (0.1790) and regulator (0.1567). The value of rater agreement (Kendall's coefficient of concordance) is symbolized by W having a value at 0.77 which means that among the respondents the experts have a very strong agreement (Fig. 6).

The most influence criteria in bank's cluster determined differentiation strategy: In the bank cluster, there are six criteria (Fig. 7). All respondents agreed that profitability

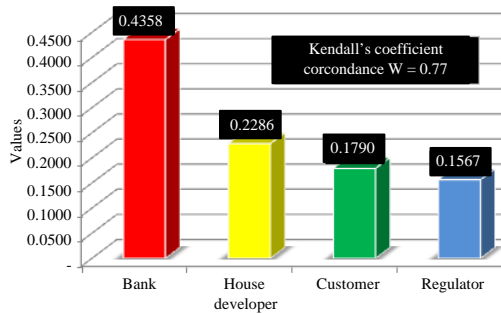


Fig. 6: ANP result on actors (cluster)

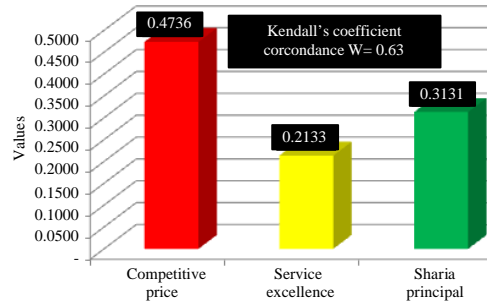


Fig. 9: ANP criteria result on customer's cluster

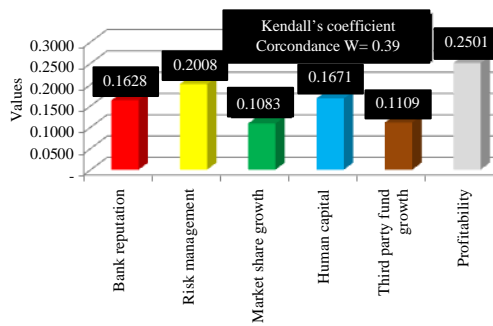


Fig. 7: ANP criteria result on bank's cluster

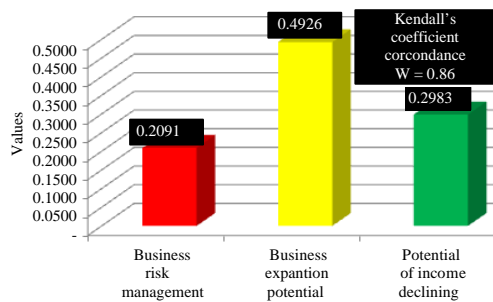


Fig. 8: ANP criteria result on house developer's cluster

is the most influential criterion in determining the strategy in selecting Islamic home financing product with geometric mean (μ) equal to 0.2501 and $W = 0.39$ which means moderate agreement. Geometric mean value of risk management is also near to profitability criterion ($i = 0.2008$) confirming the rules of *fiqh muamalah al kharaj bi al dhaman* (gaining income with being responsible for any expenses) or *al ghurmu bi al ghurmi* (return goes along with risk).

The most influencing criteria in house developer's cluster determined differentiation strategy: In house developer cluster, there are three main criteria (Fig. 8). All respondents agreed that the potential of business

expansion is the most influential criterion in determining the strategy of selecting Islamic home financing with geometric mean (μ) value at 0.4926 and rater agreement of $W = 0.86$ which means very strong agreement. For house developers, cash flow and liquidity are vital aspects in conducting business. The speed of converting inventory into cash will determine the company's liquidity. The incoming cash will be used by the house developer to build the next inventory unit which is expected to at least cover investment and operational costs in the short term and generate profit in the medium term during the project. This findings also confirming previous research by Partamihardja (2016) that the risks that have a high probability and high impact are the financial risks and market risk. The other risks in order are technical risk, natural risk, management risk, legal risk and political risk.

The most influencing criteria in customer's cluster determined differentiation strategy: In customer cluster, there are three main criteria (Fig. 9). All respondents agreed that the competitive price is the most influential criterion in determining the strategy in selecting Islamic home financing with geometric mean (μ) value at 0.4736 and rater agreement of $W = 0.63$, indicating strong agreement. On his research, Budi (2009) stated price sensitivity of house price to demand is -4.2% indicating that every 1% of decreasing house price will increase demand by 4.2%. It is confirmed that at present house price is quite sensitive for the customers as it will determine the amount of monthly installment paid. It also stated by Amin (2008) that lower repayment and Sharia principle are the most important variables to determine the selection of Islamic financing in Labuan Malaysia.

The most influencing criteria in regulator's cluster determined differentiation strategy: In cluster regulator, there are three main criteria (Fig. 10). All respondents agreed that higher risk of banking business is the most influential criterion for the regulator in determining the strategy of selecting Islamic home

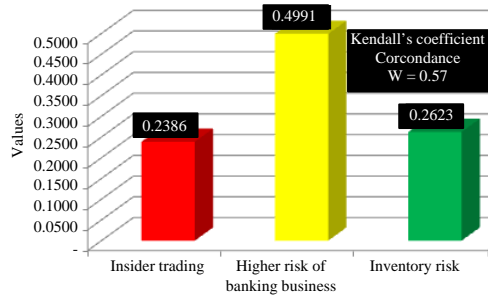


Fig. 10: ANP criteria result on regulator cluster

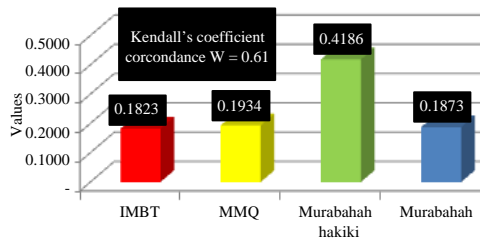


Fig. 11: ANP criteria result on product's alternatives

financing with geometric mean (μ) value at 0.4853 and $W = 0.57$ which means strong agreement. Regulator's concern is to stabilize economy by maintaining important factors to ensure bank sustainability. Business risk as result of product generated by the bank will influence the performance financial indicators such as NPF, ROA, etc. Since, the financial performance indicators (NPF, ROA, NIM/NOM, etc. as shown in Table 2) of Indonesian Islamic banks are worse than those of the conventional banks (Anonymous, 2016a, b); regulator definitely put higher risk of banking business criterion as top priority in determining differentiation strategy.

The most influencing home financing product determined differentiation strategy: Based on the ANP process, there are four main products in this research to select, i.e., IMBT, MMQ, murabahah hakiki and murabahah. The priority distribution pattern (Fig. 11) reveals that the best Islamic home financing product is murabahah hakiki contract. This was confirmed by Khan and Ahmed (2001) stating that murabahah contract is selected due to its lowest risk perception level in term of credit risk, mark-up risk, liquidity risk and operational risk. Murabahah hakiki is the most influential product in determining the strategy with geometric mean (μ) value of 0.4186 and rater agreement of $W = 0.61$ which indicates strong agreement. As a product, murabahah hakiki solves cash flow and liquidity issue in house developers and

also provides competitive advantage for customers due to its lower installment potential. However, there are inventory risk and insider trading risk attached that the bank should manage.

Murabahah hakiki is selected because there are a number of weaknesses compare with the other 3 products. IMBT and MMQ which have a floating rate character are considered to have similarities with the conventional banks as a result, they are weak if seen from the product differentiation value. Moreover, the sharia principles of akad murabahah at Indonesian Sharia Bank are being questioned because the ownership status of the bank is only on accounting paper and it is not exactly owned by the bank for the beginning.

CONCLUSION

Stagnation of Indonesian Islamic banking market share in the last 5 years shows that Islamic banks urgently need to set differentiation strategy to accelerate its growth. With all considerations of various aspects, home financing is business segment which is highly recommended. This research found that bank is the most influential actor in determining differentiation strategy. For this reason, it is necessary for Islamic banks to be innovative in their products and not merely become an imitator of conventional bank products. For Islamic banks, profitability becomes the main criterion in assessing product innovations. Islamic banks need to accommodate three main factors of competitive price, business expansion potential and higher risk of banking business covering all the concerns of home financing actors, i.e., banks, house developers, customers and regulator. The research found that murabahah hakiki is the best product recommended to cover these.

SUGGESTIONS

Banks should prepare specialist and competent human resources in the field of housing development to manage market risk and operational risk. Market risk arises due to two things, i.e., volatility of house price during inventory and over pricing taxation value of inventory. Operational risk may occur due to misuse of land bought or legal disputes.

The bank creates a murabahah-based product because it has lowest risk. Murabahah hakiki makes house cheaper, so that, monthly installments for customer will be competitive compare to conventional banks.

Banks need to cooperate with developers who have competence and trust but have limitations in capital and liquidity, so that, the banks have bargaining power to determine the final sale price to customers.

Regulators prepare special rules for Sharia banks in accordance with the character of the business where Islamic banks can function not only as an intermediary institution but also as a trader. In connection with the results of the research showing that bank business risk is the most influential criterion for the regulators in ensuring the sustainability of Sharia bank business, they can make rules that restrict certain portfolios.

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