

Factors Influencing Home Refinancing Decision among Muslim Customers

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Abstract: The objective of this study is to determine the factors influencing home refinancing among Muslim customers in Malaysia. For conventional banks, the common reasons are interest rate and monthly payment reduction of the loan. However, these reasons might not be applicable for bank customers who refinanced their loans by switching from conventional to Islamic home refinancing schemes. The study distributed 150 survey questionnaires for Muslim bank customers at 11 states and Federal Territory of Kuala Lumpur in February to March 2011. The findings indicated that reasons for refinancing were fluctuation of home financing profit rate, reduction of maturity period and monthly payment, good services of new banks and awareness among respondents to align their belief with their daily financial and economic practices. This study enhances the understanding of academics, scholars and bankers on factors influencing home refinancing activities, especially among Muslim customers in Malaysia. It is suggested that the future research can be done to compare home refinancing activities with the real changes in profit rates.

Key words: Home Refinancing • Islamic Banks • Muslim Customers

INTRODUCTION

Inability to have a convenient house becomes the problem for the young who just started their career and family life due to low purchasing power, especially those who live in the big city. This happens in many countries including Malaysia. Requirement for financing the house is not only depends on customers' financial security such as having permanent job and reach certain amount of monthly income but also rely on their ability to provide a minimum of 10% deposit, attorney fees, title insurance, documentation fees, stamp duty and other charges, imposed by the banks, developers and government's regulation. To solve the problem, one of the Malaysian government's efforts is to provide incentive by offering the home financing scheme to those who want to buy their first home. Customers are not required to pay 10% deposit to the financier. This scheme is known as 'My First Home Scheme'.

It is reasonable to assume that house refinancing activities starts after a few years of financing, specifically when the family members and fixed financial obligation (such as monthly car payment and children schooling) of

the mortgagor are expanding. The literature offers two main perspectives, the first one relates to economic theory and the second is related to marketing theory. While economic theory assumes that the banking activity is influenced by the fluctuation of interest rates where the customers refinance to earn lower rate of financing, the switching cost theory of marketing relates the activity to the perception of the customer on new and current banks in several aspects such as image, service quality, location and price. However, the explanation may not be totally accurate in the context of Malaysian Muslims. Malaysia has two parallel financial systems, conventional and Islamic financial system. These systems have different features of financing products and choices. For example, the interest rate is prohibited in Islam, leading to the usage of other contracts such as sales and partnership contracts. Islamic home financing as offered by domestic Islamic banks adopts several established hybrid contracts such as bay' bithaman ajil (BBA) and *musharakah mutanaqisah* (diminishing *musharakah*), in which the *musharakah mutanaqisah* product is accepted widely compared to BBA [1]. In the Islamic banking industry, the item of 'interest rate on loan' is changed to the 'profit

rate' given that the interest rate is regularly linked to *riba'* and the dissimilarity of their practices. Financing products in Islamic banks use the sales-based and partnership contracts for home financing activities and BFR (based financing rate) is used only as a benchmark to determine for banks' profit. Since Muslims are urged to apply financing activities based on Islamic teachings, their refinancing activities are assumed to be influenced by this factor of choices. Among factors that are found to influence consumers in adopting Islamic home financing are consumers' awareness, individual factors and financial institution factors [2]. However, studies on factors relating to consumers' reason in refinancing their home loan are limited.

A potential home loan customer faces many complex financial decisions. Initially, the home owners have to decide the initial down payment, choose an appropriate loan term and choose between fixed rate and adjustable rate loan products. After some period of time, homeowners have the option to refinance their home loans or mortgages. Homeowners' decisions or reasons can be look at from economic factors, which are listed by G-Yohanes [3] namely; (a) closing costs and prepayment penalties, (b) the difference between the interest rate on the existing loan and the interest rate on the new loan, (c) the holding period, (d) the opportunity discount rate, (e) income taxes, (f) the age of the existing loans and the remaining balance and (g) the term of the new loan. Should the new loans provide lower interest rates, the homeowners are required to pay a lower monthly home loan payment. Homeowners, therefore, have the incentive to refinance as home loans market interest rate decline [4]. However, the homeowner may incur one-time costs when he or she decided to refinance the loan, such as costs associated with origination fees, attorney fees, title insurance, documentation fees and others. Thus, decisions to refinance home loans are quite complicated.

Bennett *et al.* [4] hypothesized that the benefit of refinance had become smaller. These are due to technological advancement, regulatory and refinance awareness among homeowners. They find that the probability to refinance is influenced by the homeowners' credit rating and home equity. In addition, they observed that homeowners' postpone their decision to refinance when interest rates are volatile. Gally [5] stated that homeowners' decisions are influenced by whether owners want to choose a lower monthly payment, or faster payoff that lowered interest cost and increase in equity or a

mixture of these combinations. Using a survey method, Canner *et al.* [6] presented the incidence of refinancing, the changes in terms and condition of home loans after refinancing and the amount of funds homeowners raised in refinancing activity. They found that the decisions to refinance is motivated by homeowners desire to reduce their monthly loan payments, either through obtaining a lower interest rates loan or by extending the maturity of their loan.

Beside the above factors, Archer and Ling [7] stated that refinancing is due to demographic reasons such as change in family size or status or career based relocations. Extending Archer and Ling [7], Dickinson and Henson [8] suggest that refinancing are motivated by movement in the level of interest rates and by borrowers' desires to change their capital structures in the face of changing income and housing wealth. In addition, Campbell [9] examines the effect on refinancing behaviour including the loan problem and the income problem. Among others, the author contend that the young, smaller, better educated and better off homeowners are more likely to refinance their home loans.

Beside economic reasons, the decisions to refinance home loans can also be based on marketing perspective. There are numerous studies investigating the choice of a bank or an institution from the point of basic transaction banking services. However, reasons or choices of refinance activity from marketing perspectives have been largely overlooked.

Boyd *et al.* [10] analysed the selection criteria for retail banks. They found that customers indicated that banks' reputation, modern facilities, location, opening hours and friendliness of the staff as factors in selecting banks. On the other hand, Elliot *et al.* [11] and Reeves and Bednar [12] found that speed, access and customer services are important factors in selecting banks. Meanwhile, Ford and Jones [13] showed that customers choose their home loans with the same organisation which they have previously had a home loan. In addition, the reputation of the bank or the lender is also a factor for customers in selecting home loan. In deciding to refinance a home loan, homeowners take into consideration several factors and these decisions are not easy to make. Indeed, as summarized by Basciano *et al.* [14] a degree of awareness and sophistication is required for a homeowner to make a proper refinancing decision. Thus, the objective of this paper is to determine the factors affecting home refinancing among Muslims customers in Malaysia.

MATERIALS AND METHODS

Survey Instrument: This study uses a cross-sectional research design in which information were collected from any given sample of population elements only once [15]. This study also employed a survey method by distributing questionnaires. The survey method was chosen because it is an approach that uses several basic procedures to obtain information from people in the natural environment [16]. Data were collected using self-administered questionnaires. A total of 150 questionnaires were distributed in 12 states (Selangor, Negeri Sembilan, Melaka, Johor, Pahang, Terengganu, Kelantan, Pulau Pinang, Kedah, Perak and Sabah) and Federal Territory of Kuala Lumpur, within February to March 2011. Since this is a preliminary study, a simple random sampling technique was used in distributing the questionnaires.

The questionnaire contained four sections. The first section captured demographic information of the respondents including age, gender, highest qualification level, residential state, household income when applying for housing loan and the price range of the house. The demographic questions in this section were close-ended. The second section asked about home loan refinancing. The third section was on the reasons for loan refinancing and the fourth section had an open-ended question on intention to refinance loans. The second and third section of the survey instrument employed both close-ended and open-ended questions.

RESULTS AND DISCUSSION

Demographic Profile: From the total of 150 responses received, only 103 (68.7%) were usable for further analysis. A total of 43 responses were discarded due to missing information in which the respondents did not answer 50% or more of the survey.

A better understanding of the respondents can be obtained by examining their demographic profile. Majority of the respondents were male (76.7%). In term of price range of the house, majority bought a house in the range of RM100, 001 - RM200, 000 (48.5%). Table 1 summarizes the respondents' profile.

Home Loan Refinancing: All respondents currently have an Islamic housing loan and have refinanced their house from conventional to Islamic housing loan. Some of them refinanced their house using the same bank; and recently switched their loan from conventional to Islamic housing

Table 1: Respondent profile

Variable	Frequency	Percentage
Age (years):		
Below 30	4	3.9
31 to 40	42	40.8
41 to 50	52	50.5
51 to 60	5	4.9
Gender:		
Male	79	76.7
Female	24	23.3
Highest education level:		
SPM and below	6	5.8
Diploma	13	12.6
Bachelor degree	40	38.8
Master degree	42	40.8
PhD	1	1
Others	1	1
Residential state:		
Selangor	26	25.2
Negeri Sembilan	17	16.5
Melaka	13	12.6
Johor	18	17.5
Pahang	8	7.8
Terengganu	1	1
Kelantan	3	2.9
Pulau Pinang	4	3.9
Kedah	2	1.9
Perak	4	3.9
Sabah	1	1
Kuala Lumpur	6	5.8
Household income when applying housing loan:		
RM1,500 and below	4	3.9
RM1,501 - RM3,000	23	22.3
RM3,001 - RM4,500	39	37.9
RM4,501 - RM6,000	22	21.4
RM6,001 - RM7,500	8	7.8
RM7,501 and above	7	6.8
Household income when applying house refinancing:		
RM1,500 and below	4	3.9
RM1,501 - RM3,000	22	21.4
RM3,001 - RM4,500	33	32
RM4,501 - RM6,000	27	26.2
RM6,001 - RM7,500	9	8.7
RM7,501 and above	8	7.8
Price range of the house:		
Below RM100,000	9	8.7
RM100,001 - RM200,000	50	48.5
RM200,001 - RM300,000	36	35
RM300,001 - RM400,000	6	5.8
RM400,001 - RM500,000	1	1
RM500,001 and above	1	1

Note: USD1=RM3.20.

Table 2: Reasons for loan refinancing

Variable	Frequency	Percentage
Rate of the housing loan:		
Change from adjustable rate loan to fixed rate loan	73	70.9
Change from fixed rate loan to adjustable rate loan	29	28.2
Others	1	1.0
Maturity:		
Change to a longer maturity loan	54	52.4
Change to a shorter maturity loan	44	42.7
*Missing (did not answer the question)	5	4.9
Maturity (years):		
Less than 20 years	28	27.2
More than 20 years	55	53.4
*Missing (did not answer the question)	20	19.4
Monthly payment:		
Change to higher monthly payment	42	40.8
Change to lower monthly payment	57	55.3
*Missing (did not answer the question)	4	3.9

loan. About two-third of the respondents (76.7%) is first time house buyers. Regarding the contract used in the current housing loan, 95 respondents (92.2%) chose *bai' bithaman ajil*, six respondents (5.8%) opted for *musharakah mutanaqisah* and two respondents stated others without classifying the type of contract selected.

Reasons for Loan Refinancing: Table 2 shows the reasons for loan refinancing. Loan rate is one of the reasons of the refinancing activity [3-4]. The findings indicate that about 71% of the respondents changed their loan from adjustable to fixed rate loan. The results of this study were similar with Canner *et al.* [6], where they also observed that nearly three quarters of their respondents who had an adjustable rate home loan before refinancing switched to fixed rate home loans. Furthermore, more than 50% of the respondents changed to a longer maturity loan when they refinance their home loan.

When asked whether there were any costs incurred in the refinancing activity, majority said no. However, there were some who claimed that there were several costs involved in the activities. The costs were lawyer and legal fees, transaction or application fee, stamp duty, MRTA (Mortgage Reducing Term Assurance) cost, service charge, disbursements fee and insurance. These findings were consistent with Bennett *et al.* [4].

For the open-ended question of other reasons related to the housing loan product, majority did not answer. Some listed better offer, to save more money, change to Islamic loan, avoid *riba'*, no moving cost, need extra cash

to pay off credit card and wish to consolidate two loans into one. Our finding is consistent with the view of Dickinson and Henson [8], particularly related to borrowers' desires to change their capital structures in the face of changing income and housing wealth. The respondents in this study might need to save money or need extra cash to pay off credit card due to changes in their income.

Question on previous and current bank captures bank reputation and services such as image and quality of staff. Most of the respondents stated that interesting, good, fast and efficient services are very important. These results were consistent with the marketing perspective of financial services industry, where banks' reputation, modern facilities, location, opening hours and friendliness of the staff as factors in selecting banks, as found by Boyd *et al.* [10], Elliot *et al.* [11] and Reeves and Bednar [12]. Some respondents mentioned that their previous bank did not know how to handle many customers compared to the current bank which has friendly staff to entertain customers.

The section on individual preferences captured other reasons such as awareness or information that have an impact on the respondent's decision to refinance their house. Some of the reasons are as follow: (a) awareness to change to *shariah* compliance product; (b) friendlier and more helpful staff; (c) online services; (d) easier to get information from the bank; (e) user-friendly website; (f) information about the product; and (g) staff must have good information about the product.

CONCLUSION

The study conclude that the reasons for refinancing activities among Malaysian Muslims were the fluctuation of home financing profit rate, reduction in the maturity period and monthly payment and good services of new banks. While interest rate on conventional loan is the main factor for refinancing activities, respondents of this study also considered the profit rate even though the treatment of these two variables are different in practice. The findings imply increasing awareness among Muslims in Malaysia to align their belief with their daily financial and economic practices when applying for home loan refinancing. Therefore, future studies should investigate the behaviour of financing transactions among Muslims by comparing interest rates and profit rates volatilities related to home financing. Another potential research area is to compare refinancing activities with the real changes in profit rates.

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