

The Role of Islamic Collateral Loans (Ar-Rahnu) in the Malaysian Credit System: Evidence from Customer's Borrowing Behaviors

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I Introduction

Since the rise of the Islamic financial industry mainly in 1970s, many types of Islamic financial products have been developed and expanded, not only to Muslim but also non-Muslim. At present, Islamic microfinance is one of the important issues in the academic field of Islamic economics and finance.

In Malaysia, one of the leading countries in the Islamic financial industry, it is said that Ar-Rahnu, whose name comes from *rahn* in Arabic, functions as Islamic microcredit [Ahmad 2011; Maamor and Ismail 2013; Samsudin 2014]. Ar-Rahnu can be regarded as a contemporary application of *rahn* [Muhammad and Ahmad 2016: 284]. In some texts of Islamic finance studies, Ar-Rahnu has been defined as “Islamic pawnbroking” [Ahmed 2006: 33; Rosly 2005: 129-132].

Since the 1990s, public institutions in Malaysia have been the primary providers of Ar-Rahnu. At present, this is one of the most popular Islamic financial products for Malaysian people. The total loan balance of Ar-Rahnu provided by Bank Rakyat, an Islamic cooperative bank in Malaysia, was RM 1.9 billion, or 38 percent market share in Malaysian Ar-Rahnu business [UO 2016].

Some studies conclude that Ar-Rahnu has contributed to customers' economic lives, providing cash mainly for living expenses or business capital easier, faster, and less expensively than a pawnshop loan. However, little attention has been given to the amount of loan by purpose or the customers' preferences for Ar-Rahnu in the Malaysian credit system.

Therefore, this study aims to explore the role of Ar-Rahnu in customers' borrowing. This study asks the following questions: How is Ar-Rahnu used in the Malaysian economy? What are the potential financing alternatives to Ar-Rahnu? What is the impact of Ar-Rahnu in the context of financing in Malaysia? By answering each of these questions and considering them together, we can achieve the study's goal. However, to answer these questions, it is necessary to research customers' borrowing behaviors and preferences for Ar-Rahnu, as well as other financing methods.

This paper is organized as follows. The following section describes the development and procedures of Ar-Rahnu, while section 3 reviews previous research of Ar-Rahnu's role in credit behaviors in Malaysia. Section 4 discusses the research methods used in the study.

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Section 5 explains the details of the survey conducted in Malaysia. The results of the survey and a discussion are presented in Section 6. Finally, section 7 presents the conclusions about the role of Ar-Rahnu by answering the research questions.

II Ar-Rahnu in Malaysia

1. Development of Ar-Rahnu

Table 1 History of Ar-Rahnu in Malaysia

Year	Name of Institutions	Abbreviated name
1990	Speech by Tan Sri Dato's Jaffar bin Hussein	-
1992	Terengganu's Islamic Pawnshop Corporation	MGIT
	Permodalan Kelantan Berhad	PKB
1993	Bank Kerjasama Rakyat Malaysia Berhad	BR
	Seminar by Persatuan 'Ulama' Malaysia	-
1998	Bank Islam Malaysia Berhad	BIBM
2000	Malaysian Islamic Economic Development Foundation	YaPEIM
2002	Bank Pertanian Malaysia Berhad	AgroBank
2010	Habib	
2012	Koperasi Angkatan Tentera Malaysia Berhad	Koperasi Tentera/KT
	Pos Malaysia Berhad	Pos Malaysia

The chronology in Table 1 shows the years when speeches or seminars about Ar-Rahnu were held in Malaysia, and the first years when financial and non-financial institutions began to offer Ar-Rahnu.

Ar-Rahnu was first mentioned in a speech as one of the financial schemes in the Malaysian welfare system [Jaffar bin Hussein 1991]. The speech was titled "Islamic Financial System in the Decade of the 1990s," or "Sistem Kewangan Islam dalam Dekad 1990-an" in the Malay language. The speech was authored by Tan Sri Dato's Jaffar bin Hussein, who served as the Governor of the Bank Negara Malaysia from 1985 to 1994, and was given at the Universiti Sains Malaysia on March 9, 1990. In his speech, he mentioned the possibility of pawnbroking, called *al-raham* in Islam. He suggested that its purpose is to act as a financial channel for providing for the welfare of income-low groups, not to pursue profits [Jaffar bin Hussein 1991: 16].

Public institutions now offer Ar-Rahnu in Malaysia. Initially, local governments in the northeast part of the country introduced this financial service as part of an Islamic development plan. Muassasah Gadaian Islam Terengganu, MGIT (Terengganu's Islamic Pawnshop Corporation) began providing Islamic pawn-broking services in January, 1992. This corporation was established by Majlis Agama Islam dan Adat Melayu Terengganu,

MAIDAM (Terengganu Religious and Malay Custom Council), which aims to achieve the socio-economic development of Malay-Muslims. This service was also introduced in March, 1992 by Permodalan Kelantan Berhad, which is one of the subsidiaries of the Kelantan State Economic Development Corporation (KSEDC) in Kelantan.

Ar-Rahnu was taken up not only as specific state policies, but also as a wide-ranging products in Malaysia. The seminar “National Seminar on Islamic Pawnbroker,” or “Seminar Kebangsaan Pajakgadai Islam (Ar-Rahn)” in Malays was organized at Subang Jaya on December 13, 1993, by Ulama’s association in Malaysia, Persatuan ‘Ulama’ Malaysia. In this seminar, five resolutions were presented to promote realization of Islamic pawnbroking. One of the resolutions at the seminar was a call for governments in Malaysia to operate the Islamic Pawnbroking system as an easy loan channel with a very small fee for low-income groups [Persatuan ‘Ulama’ Malaysia 1993].

After these states began providing Islamic pawn-broking services, some domestic Islamic financial institutions introduced and expanded the service. Bank Kerjasama Rakyat Malaysia Berhad, one of the largest Islamic cooperative banks, introduced the service in its six branches, using by capital from Yayasan Pembangunan Ekonomi Islam Malaysia, YaPEIM (Malaysian Islamic Economic Development Foundation). Of the commercial banks, Bank Islam Malaysia Berhad, the first Islamic bank in Malaysia, introduced the service at its branch in Kelantan in 1998. In 2000, YaPEIM, whose goal is to solve the poverty problem in Malaysia, also began offering it.

Non-financial institutions started to provide the Islamic pawn-broking service to their customers in the 2000s. The most well-known example is the Pos Malaysia Berhad, which mainly acts as the postal service in Malaysia. At the beginning, two branches of this company, Baru Bangi in the state of Selangor and Kuala Terengganu in the state of Terengganu, introduced this service. In July 2013, fifty branches of the company started to provide windows for the service. Other institutions providing this service since 2000 are Habib, which is a famous jewelry shop, and Koperasi Angkatan Tentera Malaysia Berhad, which means an association for the Malaysian army which role is similar to in a savings and loan association.

2. Ar-Rahnu Procedure

2-1. Ar-Rahnu Scheme and Background

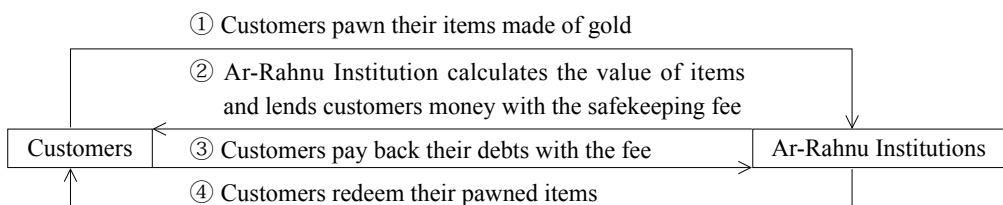


Figure 1. Ar-Rahnu Procedure

The *Rahn* contract, one of the contracts establishing the Ar-Rahnu product is defined in Islamic jurisprudence as holding an item with a legal right that may be satisfied by payment of a debt. In other words, it is defined from the perspective of Islamic law as enabling goods and chattels (*'ayn*) properties with value to be pledged against a debt so that the debt can be collected partly or fully from the item [Zuḥaylī 1997: 4207].¹ As a consensus (*ijmā'*), Muslims agree that pawning is permissible [Zuḥaylī 1997: 4210].

Ar-Rahnu was established by revitalizing the *rahn* contract in Islamic jurisprudence. The Ar-Rahnu financing scheme consists of three contracts, which are *rahn*, *qard ḥasan*, and *wadī'a yad ḍamāna*. Figure 1 shows the procedure for a customer to take out on Ar-Rahnu loan. A customer first takes items to an Ar-Rahnu institution, where the staff there calculates the value of the items, and then provides an interest-free loan (*qard ḥasan*) to the customer. *Qard ḥasan*, which means “good loan,” is an interest-free loan for financing a welfare project or fulfilling short-term requirements [Ahmed 2006: 35]. By the maturity date, the customer pays back the debt plus a safekeeping fee (*ujra*) for safe custody based on trust (*wadī'a yad ḍamāna*), which is a contract for safely keeping the customer's items. Unlike pawnshops, Ar-Rahnu institutions do not charge customers interest because interest charged by pawnshops is *ribā*, or prohibited in Islam. After that, the customer redeems the pawned items from the institution.

2-2. Modernization of the *rahn* Contract

As previously noted, the Ar-Rahnu scheme was developed based on the *rahn* contract. There are two differences between a *rahn* contract and Ar-Rahnu described in this section.

The first difference is that Ar-Rahnu is a commutative contract, while the *rahn* contract is a noncommutative contract. There are two types of contracts with respect to the counter value in a financial transaction exchange under Islamic jurisprudence. One is a compensatory/commutative contract (*mu'āwada*), while the other is a noncommutative contract (*tabarru'*) [Ayub 2007: 124]. *Rahn* is regarded as a *tabarru'* contracts [Zuḥaylī 1997: 4208].² This is because the pawned object is given without financial compensation, and the contract itself is not forced. However, Ar-Rahnu institutions provide safekeeping services and charge a safekeeping fee (*ujra*) as compensation for the services.

Second, there are differences between the conditions for collateral in a *rahn* contract and those in Ar-Rahnu. There are roughly six conditions for collateral in a *rahn* contract. The collateral must (i) exist at the inception of the contract, (ii) be deliverable, (iii) be owned, (iv) be properly valued, (v) be known, and (vi) be received [Zuḥaylī 1997: 4230–4236; Zuḥaylī

¹ The following translation from Arabic to English was done by the author, but with reference to [Zuḥaylī 2003].

² Zuḥaylī mentions a gift (*hiba*), a loan for use (*i'āra*), a deposit (*idā'*), and a loan for consumption (*qard*) as other *tabarru'* contracts [Zuḥaylī 1997: 4208].

2011: 83–84]. In contrast, for Ar-Rahnu, institutions stipulate that customers must pawn a gold item, such as earrings, a necklace, a ring, or an anklet. Therefore, the kind of collateral items for Ar-Rahnu are restricted to gold items, compared to the various kinds of items permitted in a *rahn* contract.

III Literature Review

Previous research indicates that there are two typical roles for Ar-Rahnu in Malaysia: a quick and easy loan for low-income groups, and credit for small and medium-sized enterprise (SMEs). Regarding the former role, Maamor and Ismail [2013: 38] show that “Ar-Rahnu is defined as one of the Islamic credit institutions that provide interest-free loans, conditioned on the ability to pledge assets, often targeting lower income households ...”. For the latter role, Maamor and Ismail [2013: 54–56] explain that SMEs prefer borrowing cash from pawnshops to borrowing from financial institutions, such as commercial banks.³ Maamor and Ismail [2013: 56] also show that while the lower transaction cost of a pawnshop loan compensates for the higher interest rate charged by the pawnshop, customers prefer Ar-Rahnu because the loan is less expensive than one from a pawnshop. However, little study has been done on the roles in the context of the Malaysian economy.

Over the past few years, many studies have claimed that Ar-Rahnu has significant consequences for Malaysian credit behavior and the social-economy [Abudul-Razak 2011; Maamor and Ismail eds. 2013; Samsudin 2014]. However, the question remains whether it is meaningful to compare the conditions and characteristics of an Ar-Rahnu loan with those of a pawnshop to demonstrate the impact of Ar-Rahnu on Malaysian credit behavior.

Most studies have shown the impact of Ar-Rahnu through a questionnaire survey of the customers, using comparisons to pawnshops. For example, Abudul-Razak [2011] concludes that the Islamic pawnbroking system demonstrates positive attributes, such as transparency, honesty, and reliability, when as compared to conventional pawnbroking [Abudul-Razak 2011: 190]. Based on a questionnaire survey, Samsudin [2014] notes that customers understand that Ar-Rahnu is pawnbroking that complies with *sharī‘a*, and they choose Ar-Rahnu because of its five advantages, including a lower fee, the fact that it is without the *ribā* element, better security for the pawned item, more accurate measurement of the value of the pawned item, and a reasonable period of lending compared to a pawnshop’s loan from the questionnaire survey [Samsudin 2014: 7].

The problem seems to lie in the fact that most studies of Ar-Rahnu’s function emphasize the advantages compared to a pawnshop, although Ar-Rahnu is not just an alternative to

³ The reasons are transaction costs (transportation and costs of waiting for cash), the interest rate regulations, difficulty using formal financial institutions because of poverty, short duration of loans, and confidentiality of loans.

pawnshops, but also a form of microcredit. Therefore, it is important to reveal the role Ar-Rahnu plays, and whether Ar-Rahnu is really an alternative to pawnshop loans from the perspective of customers' borrowing behaviors and preferences.

IV Research Method

1. Description of Research Locations

This section describes the two towns used in this research: Ampang in the state of Selangor and Kota Bharu in the state of Kelantan.

Ampang is located in the eastern part of the Federal Territory of Kuala Lumpur. The local government is the Majlis Perbandaran Ampang Jaya (Ampang Jaya Municipal Council). The name Ampang originated from the dam constructed by Chinese miners from Bukit Belacan to the urban area of Ampang [MPAJ 2016].⁴ The area is 3,859 hectares [MPAJ 2016]. The population in 2010 was 43,522, including 26,090 Malay, 7,586 Chinese, and 3,372 Indians [Jabatan Perangkaan Malaysia 2011: 413]. More Malay people live in Ampang than in the entire Federal Territory of Kuala Lumpur. According to [Jabatan Perangkaan Malaysia 2011], the percentage of Malay in Ampang is about 60%, while that of Malay in the Federal Territory of Kuala Lumpur is about 41%.

Kota Bharu is the state capital of Kelantan, and the local government is Majlis Perbandaran Kota Bharu (Kota Bharu Municipal Council). Kota Bharu city was built in 1844, and was established as the governing center by Kebawah Duli Yang Mulia Al-Marhum Sultan Muhammad Ke-II [MPKB 2016]. The population in 2010 was 255,777, including 230,806 Malay, 16,342 Chinese, and 930 Indians [Jabatan Perangkaan Malaysia 2011: 47], so more than 90% of the population are Malay people.

2. Survey Procedure

This research adopts a questionnaire survey to answer the above research questions. The target was Ar-Rahnu X'Change. According to Rakyat Management Services [2017], it is defined as a franchise that offers Islamic collateral loans under Bank Rakyat. First launched in December 2006, today it has 110 outlets nationwide. There are 220 total respondents, and the sample consists of 107 respondents in Ampang, and 113 respondents in Kota Bharu.

The survey took place from August 30 to September 8, 2016 in Ampang, Selangor state, and Kota Bharu, Kelantan state. It was conducted with the advance permission of Bank Rakyat. In this survey, the respondents were randomly chosen from customers, who came to the X'change shop for various reasons, and who were asked to answer the questions by filling in the questionnaire. To solve the potential language problem, the researcher explained the aim of the research and the meaning of some questions not only in English but also in Malay

4 Because of Chinese pronunciation, "empangan," which means dam in Malay, became "ampang."

(Bahasa Melayu), and prepared both Malay and English versions of the questionnaire.

3. Demographic Characteristics

The questionnaire was used to understand the demographic characteristics of the respondents and their use of Ar-Rahnu. The demographic characteristics questions consisted of questions about gender, age, ethnicity, religion, marital status, education level, number of dependents, occupation, and household income per month. The factors regarding use of Ar-Rahnu consisted of the loan purpose, loan amount, length of loan, advantages, alternatives to Ar-Rahnu, and experiences using other types of financing.

Table 2. Respondents' Gender

		Survey Data						Census Data			
		Ampang		Kota Bharu		Total		Kuala Lumpur		Kelantan	
		Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage
Gender	Female	63	60.0%	65	58.0%	128	59.0%	822,491	49.1%	765,903	49.7%
	Male	42	40.0%	47	42.0%	89	41.0%	852,130	50.9%	773,698	50.3%

Source of census data: Banci Penduduk dan Perumahan Malaysia [2011; 2013; 2015]

Table 2 shows the demographic information collected from the survey. 128 of the respondents were male (59.0%), while 89 of the respondents were female (41.0%).

Table 3. Respondents' Age

		Survey Data						Census Data			
		Ampang		Kota Bharu		Total		Kuala Lumpur		Kelantan	
		Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage
Age	18-19	1	0.9%	1	0.9%	2	0.9%	-	-	-	-
	20-29	21	19.6%	20	17.7%	41	18.6%	377,409	22.5%	225,314	14.6%
	30-39	42	39.3%	38	33.6%	80	36.4%	280,370	16.7%	172,725	11.2%
	40-49	19	17.8%	32	28.3%	51	23.2%	224,987	13.4%	175,570	11.4%
	50-59	14	13.1%	15	13.3%	29	13.2%	150,877	9.0%	137,260	8.9%
	60-	10	9.3%	7	6.2%	17	7.7%	127,825	7.6%	135,935	8.8%

Regarding customers' ages, as seen in Table 3, the greatest number of respondents were between 30 and 39 years of age, which accounts for approximately 36.5% of the total respondents, or 80 respondents. The second largest group was between 40 and 49 years of age, representing 23.3%, or 51 respondents.

Table 4. Respondents' Ethnicity and Religion

		Survey Data						Census Data			
		Ampang		Kota Bharu		Total		Kuala Lumpur		Kelantan	
		Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage
Ethnicity	Malay	97	90.7%	106	93.8%	203	92.3%	679,236	40.6%	1,426,373	92.6%
	Indian	9	8.4%	3	2.7%	12	5.5%	156,316	9.3%	3,849	0.2%
	Chinese	0	0.0%	4	3.5%	4	1.8%	655,413	39.1%	51,614	3.4%
	others	1	0.9%	0	0.0%	1	0.5%	9,539	0.6%	9,188	0.6%
Religion	Islam	99	92.5%	109	96.5%	208	94.5%	776,958	46.4%	1,465,388	95.2%
	Buddhism	0	0.0%	3	2.7%	3	1.4%	597,770	35.7%	57,792	3.8%
	Christianity	1	0.9%	0	0.0%	1	0.5%	97,241	5.8%	4,375	0.3%
	Hinduism	7	6.5%	1	0.9%	8	3.6%	142,130	8.5%	3,670	0.2%
	others	0	0.0%	0	0.0%	0	0.0%	60,522	3.6%	8,376	0.5%

Examining ethnicity and religion, 203 of the respondents were Malay (92.3%) and 208 of them were Muslim (94.5%). In Ampang, Malay or Muslim represent more than 90% of the respondents to the survey, while those in Kuala Lumpur were less than 50% of the population. In addition, all Malays in this survey were Muslim. From the results in Table 4, it is possible to argue that in the surveyed areas, more Malay Muslim use Ar-Rahnu than those who belong to other ethnicities or believe in other religions.

Table 5. Respondents' Monthly Household Income

		Survey Data						Census Data			
		Ampang		Kota Bharu		Total		Kuala Lumpur		Kelantan	
		Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage
Monthly Household Income	≤ RM1,999	20	19.2%	36	32.4%	56	26.0%	-	1.4%	-	31.4%
	RM2,000-RM2,999	25	24.0%	24	21.6%	49	22.8%	-	3.4%	-	23.4%
	RM3,000-RM3,999	14	13.5%	26	23.4%	40	18.6%	-	10.2%	-	15.8%
	RM4,000-RM4,999	16	15.4%	9	8.1%	25	11.6%	-	9.8%	-	8.9%
	RM5,000-RM5,999	15	14.4%	5	4.5%	20	9.3%	-	10.8%	-	5.3%
	RM6,000-RM6,999	0	0.0%	5	4.5%	5	2.3%	-	9.2%	-	3.5%
	RM7,000-RM7,999	3	2.9%	1	0.9%	4	1.9%	-	7.5%	-	2.6%
	≥ RM8,000	11	10.6%	5	4.5%	16	7.4%	-	47.7%	-	9.1%

Table 5 shows that those with monthly household income less than RM 3,999, which are almost categorized as low-income by the Economic Planning Unit [2015],⁵ accounts for 67.4% of the respondents to the survey.

⁵ Household incomes of less than RM 3,860 are categorized as low-income. In addition, those between RM 3,860 and RM 8,319 and more than RM 8,319 are categorized as middle-income and high income, respectively [Economic Planning Unit 2015].

Previous research has shown credit for low-income groups as one of Ar-Rahnu's roles. Similarly, about 70% of the respondents in this survey belong to a lower income group.

Table 6. Respondents' Occupational Distribution

		Survey Data						Census Data			
		Ampang		Kota Bharu		Total		Kuala Lumpur		Kelantan	
		Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage
Occupational Distribution	Managers	8	7.5%	13	12.7%	21	10.0%	81,406	10.2%	9,636	2.1%
	Professionals	17	15.9%	13	12.7%	30	14.4%	106,042	13.3%	42,918	9.2%
	Technicians and associate professionals	4	3.7%	7	6.9%	11	5.3%	102,770	12.9%	23,413	5.0%
	Clerical support workers	19	17.8%	6	5.9%	25	12.0%	114,020	14.3%	24,814	5.3%
	Services and sales workers	15	14.0%	29	28.4%	44	21.1%	168,255	21.1%	108,704	23.2%
	Skilled agricultural, forestry, and fishery workers	2	1.9%	1	1.0%	3	1.4%	380	0.0%	77,497	16.6%
	Craft and related trades workers	2	1.9%	2	2.0%	4	1.9%	49,432	6.2%	77,249	16.5%
	Plant and machine operators and assemblers	0	0.0%	0	0.0%	0	0.0%	59,188	7.4%	28,403	6.1%
	Elementary occupations	8	7.5%	4	3.9%	12	5.7%	84,339	10.6%	60,571	12.9%
	Occupation inadequately described or unknown	3	2.8%	2	2.0%	5	2.4%	31,587	4.0%	14,984	3.2%
	Housewife	21	19.6%	20	19.6%	41	19.6%	-	-	-	-
	Pensioner	5	4.7%	4	3.9%	9	4.3%	-	-	-	-
	Student	3	2.8%	1	1.0%	4	1.9%	-	-	-	-

Table 6 presents the occupations of the survey respondents. Service and sales workers and housewives represent about 20% of the occupational distribution. In Kota Bharu, managers represent more than 12.7% of survey respondents, while they are about 2% of the population in Kelantan. These results coincide with previous studies such as Abudul-Razak [2011] and Zainal and Tahir [2013] in that most Ar-Rahnu customers are housewives or belong to low-income groups.

3. Identifying Customers' Borrowing Behaviors and Preferences

This study focuses on the borrowing purpose and amount of loans to identify the real role of Ar-Rahnu in Malaysia. The survey offered general and detailed choices for respondent's answers regarding the borrowing purpose. The respondents first chose living expenses, educational expenses, or business capital for the general purpose. Second, they chose a detailed purpose for every general purpose. The survey included food expenses, house renovation, wedding expenses, debt payment, or others for living expenses; university expenses or others for educational expense; and enterprise capital, working capital, or others for business capital.

The customers were asked to indicate the amount of the loan on the questionnaire. In cases where the respondents completed the survey before borrowing, they were asked to indicate the expected amount of the loan.

To indicate the role of Ar-Rahnu for customers, the questionnaire included the following question:

“Besides Ar-Rahn, which other sources do you use to get financing?”

The following choices were given for the answer in this question: friends, family, bank loan (both Islamic and conventional), conventional pawnshops, moneylender, and others. When the respondents answered the question, the researcher told them to imagine a situation where they had to borrow money from a source other than Ar-Rahnu.

V Results

1. Purpose and Amount of Borrowing

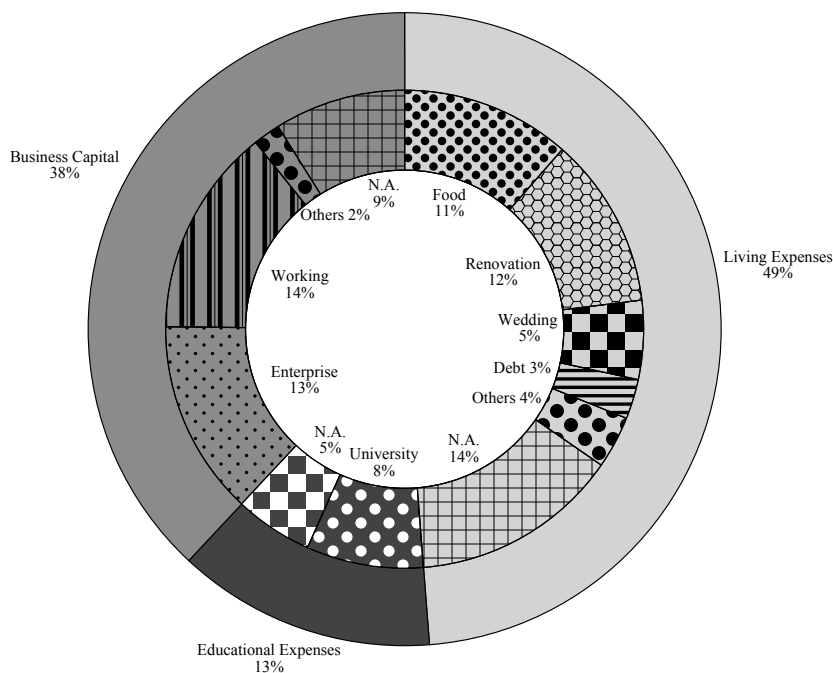


Figure 2-1. Purposes of Ar-Rahnu in Ampang

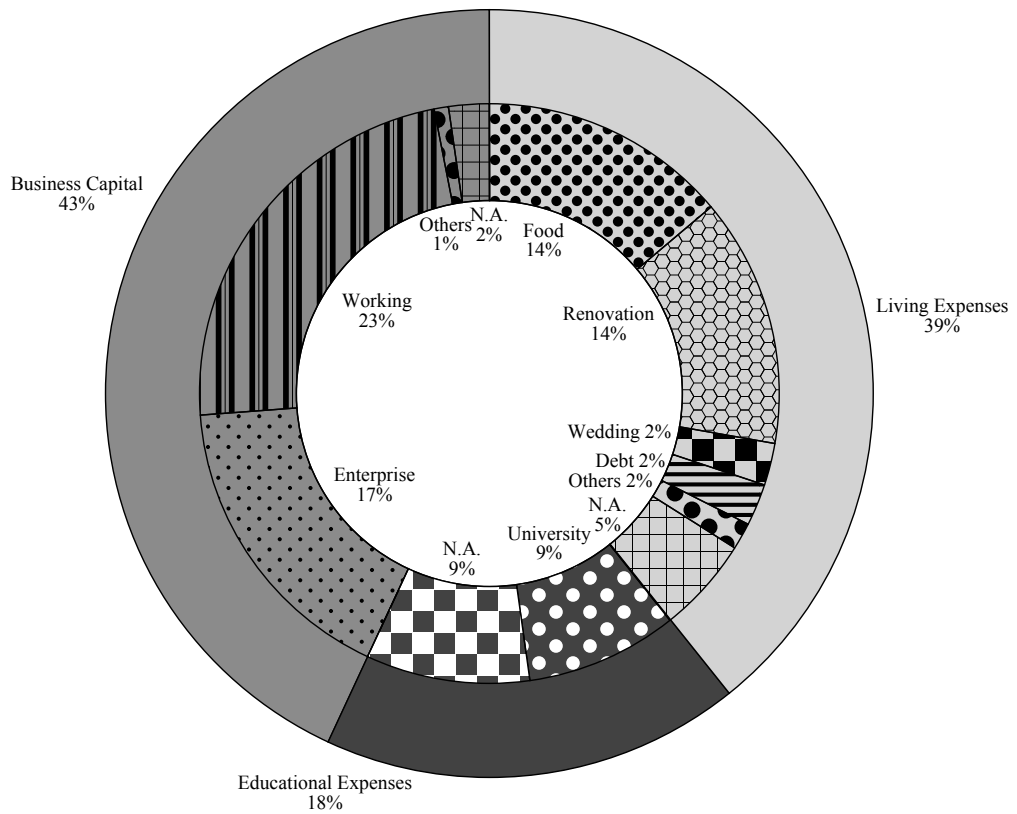


Figure 2-2. Purposes of Ar-Rahnu in Kota Bharu

Figures 2-1 and 2-2 show the proportions of borrowing purposes from Ar-Rahnu in Ampang and Kota Bharu. The outer circle indicates the three general borrowing purposes, and the inner circle shows the detailed purposes. As these figures indicate, there is a similarity between the results in Ampang and Kota Bharu in the distribution: Ar-Rahnu is mainly used for living expenses and business capital.

This result is consistent with the findings of previous researches that Ar-Rahnu is used for helping people's everyday lives, and as business capital for SMEs. Similarly, this study finds that Ar-Rahnu contributes to people's lives and business, as seen from the figures.

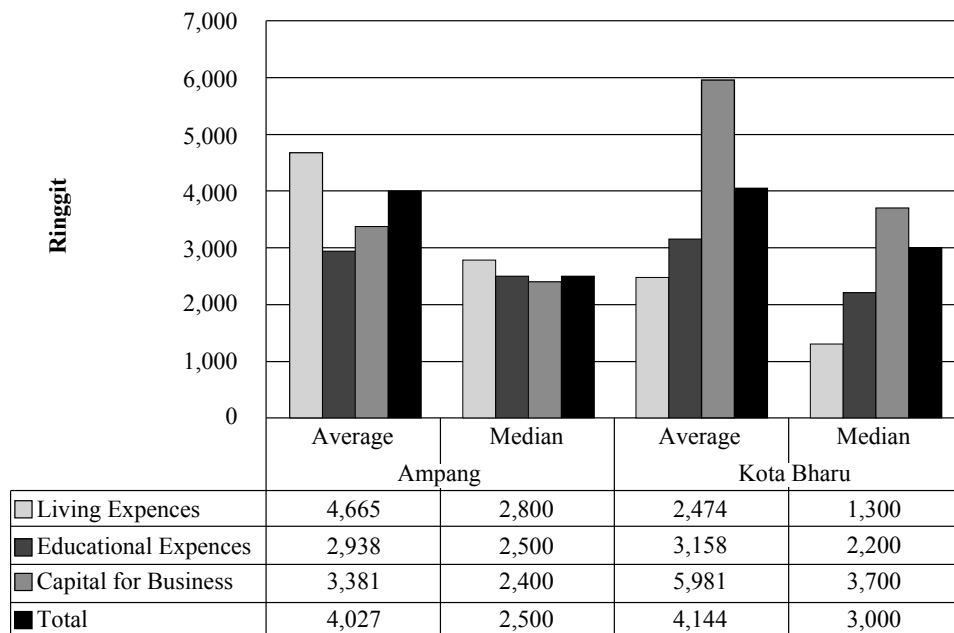


Figure 3. Average and Median Ar-Rahnu Loan by Borrowing Purpose

Figure 3 shows the quantitatively data, indicating the average and median of Ar-Rahnu loans by borrowing purpose in Ampang and Kota Bharu. From this figure, we can see that the role of Ar-Rahnu differs depending on the regions. In Ampang, the average and median of living expenses, RM 4,665 and RM 2,800 are greater than the average and median of the total, RM 4,027 and RM 2,500. From this result, it can be seen that Ar-Rahnu plays a greater role in customers' household consumption, such as food expenses and renovating their houses, than for other purposes.

In contrast, the average and median amounts for business capital, RM 5,981 and RM 3,700, respectively, are more than those of the totals, RM 4,144 and RM 3,000 in Kota Bharu. Ar-Rahnu loans in Kota Bharu are more actively used for customers' productive activities, such as starting an enterprise or continuing a business, than for other uses.

As seen in Figure 2, the distribution of borrowing purposes for Ar-Rahnu loans follows the argument of previous research. However, by focusing on the amount of respondents' borrowing by purpose in Ampang and Kota Bharu, we can see that the degree of Ar-Rahnu's role depends on the region.

2. Role of Ar-Rahnu

2-1. Alternatives to Ar-Rahnu

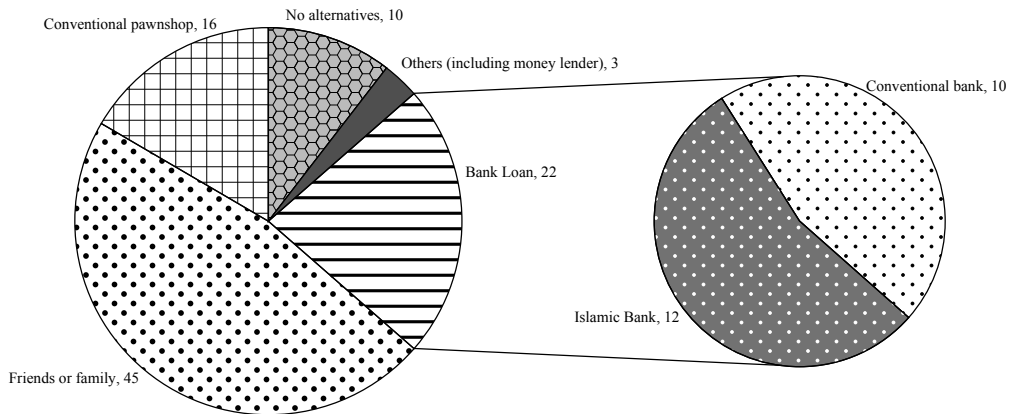


Figure 4-1. Alternatives to Ar-Rahnu in Ampang

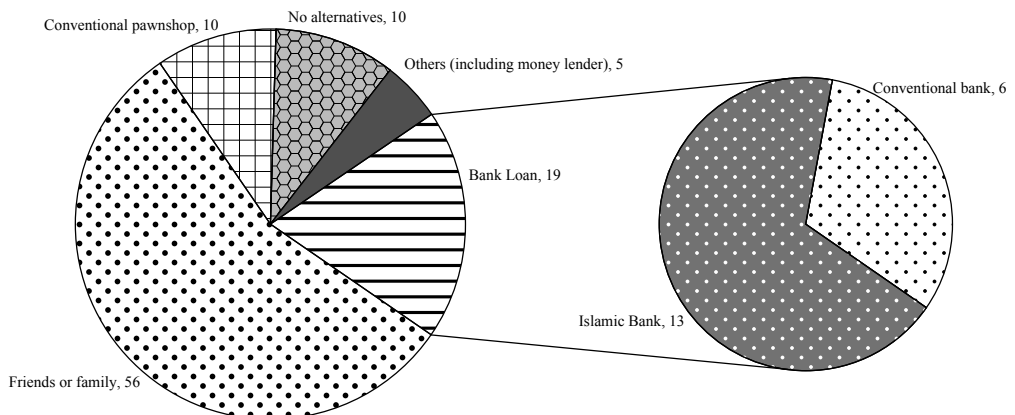


Figure 4-2. Alternatives to Ar-Rahnu in Kota Bharu

Tables 4-1 and 4-2 show the substitute financing methods for Ar-Rahnu. It became clear from this survey that most substitute financing for Ar-Rahnu is from friends or family, which is a part of informal finance. Without Ar-Rahnu, 45 respondents out of 96 in Ampang and 56 respondents out of 100 in Kota Bharu answered that they would borrow money from friends or family members. About 46.9% of the respondents in Ampang and 56% of the respondents in Kota Bharu preferred this method.

Moreover, following financing from friends and family, we can see that bank loans are preferred. Bank loans were preferred as an alternative to Ar-Rahnu by 22 respondents out of 96 in Ampang and 19 respondents out of 100 in Kota Bharu. The method was preferred by 22.9% and 19% of the respondents in Ampang and in Kota Bharu, respectively. In

addition, for bank loans as an alternative to Ar-Rahnu, bank loans from Islamic banks such as Bank Rakyat and Bank Islam Malaysia Berhad were preferred to conventional bank loans. From these results, it is possible to argue that financing from friends, family, and Islamic or conventional banks are regarded as more popular alternatives to Ar-Rahnu than other financing.

It is interesting to note that few respondents regard a pawnshop as an alternative to Ar-Rahnu; nevertheless, there is a similarity in their methods of financing. A conventional pawnshop is the third substitute financing method for Ar-Rahnu in Ampang and Kota Bharu. This method was preferred by 16.7% and 10% of the respondents in Ampang and in Kota Bharu, respectively.

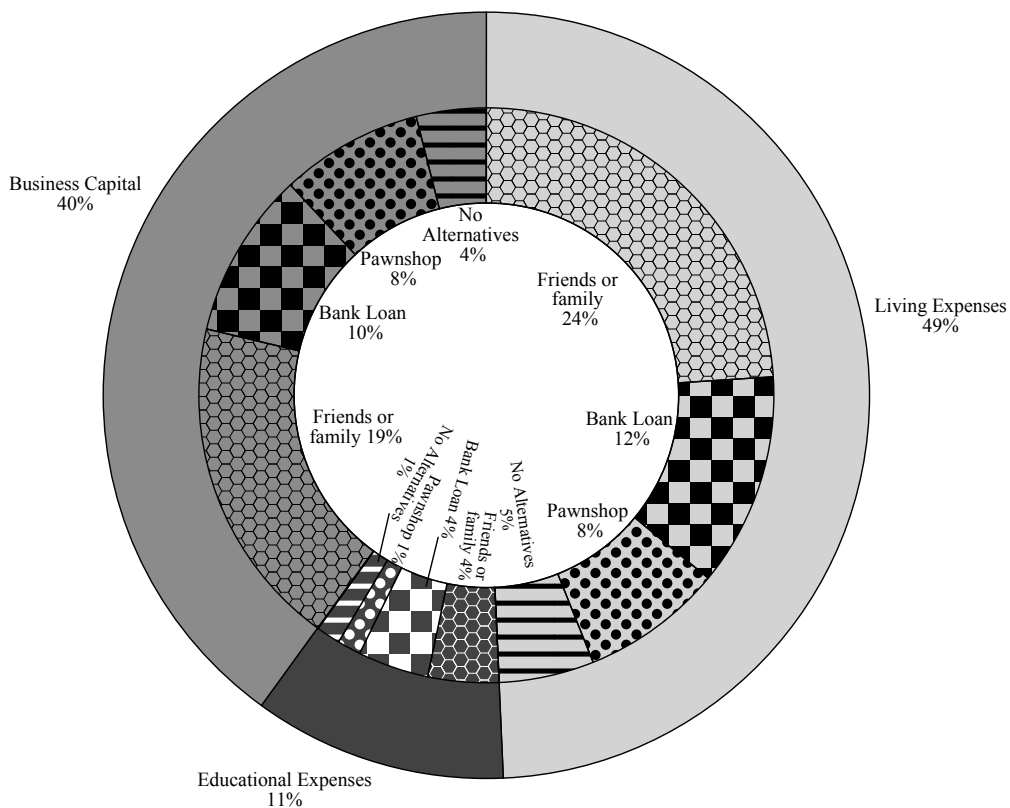


Figure 5-1. Purpose of Ar-Rahnu and Alternatives in Ampang

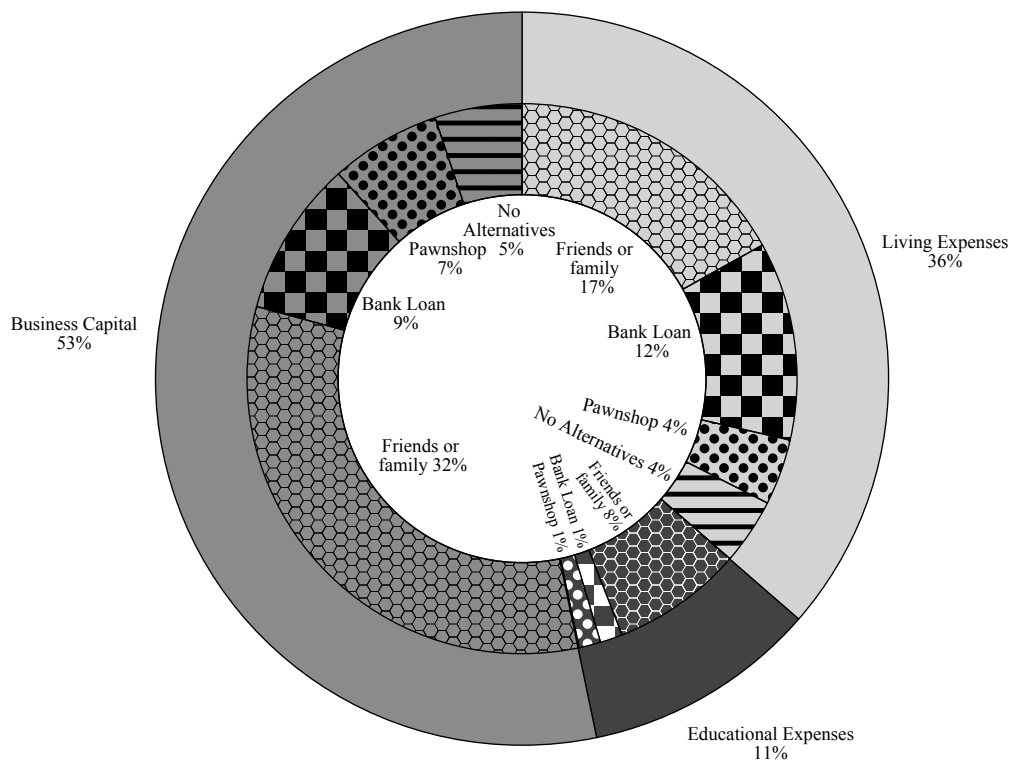


Figure 5-2. Alternatives to Ar-Rahnu by Use Purpose in Kota Bharu

Figures 5-1 and 5-2 show the relationship between purposes and alternatives to Ar-Rahnu. The outer circle represents the percentage of general purposes of Ar-Rahnu loans and the inner circle indicates alternatives to Ar-Rahnu for each purpose. From these figures, we can see that regardless of the region, around 50% of the respondents regard financing from friends or family as an alternative to Ar-Rahnu in each of the main purposes of living expenses and business capital. Especially in Kota Bharu, the item represents 32% of all respondents, or about 60.4% of the respondents who borrow to obtain business capital. Therefore, the results show that about half of Ar-Rahnu customers assume that they would borrow from their friends or family without Ar-Rahnu.

VI Discussion

In this study, we have seen the roles of Ar-Rahnu in customers' borrowing. This study considers three research questions to achieve its goal. The first question is how Ar-Rahnu is used in the Malaysian economy; the second is what would be the alternative to financing through Ar-Rahnu; and the third is the impact of Ar-Rahnu in the context of financing in Malaysia.

Based on our results, we can provide the following answers for these research questions. For the first question, while the results of this survey follow previous research in that Ar-Rahnu plays roles in helping with Malay people's consumption and productive activities, we find that the loan sizes for the two roles differ depending on the region. In other words, this study reveals that the roles of Ar-Rahnu are not uniform but reflect the regional differences in the Malaysian economy.

For the second question, we can see that regardless of the region, more respondents regard financing from friends or family as the alternative to Ar-Rahnu than a pawnshop loan. On the other hand, it is evident from this survey that it is hard to say that pawnshop loans play a role as an alternative to Ar-Rahnu.

For the third question, it is significant that for small and medium-sized enterprises (SMEs), finance from friends or family comes after Ar-Rahnu in the borrowers' preferences for debt financing. The trend in Kota Bharu is remarkable, that based on the data, about 60.4% of the respondents who finance for obtaining business capital answer that they would finance from friends or family if there was no Ar-Rahnu. The preference of customers using Ar-Rahnu is inconsistent with the priority order of SME financing in previous research.

There is a hypothesis that SMEs in Malaysia prefer self-financing and financing from internal funds, such as personal or family savings, to financing with external funds, such as equity or debt. Some studies claim that as the results of their surveys show that SMEs tend to finance from their own capital or family-owned capital [Shahadan and Berma 2004; Manan and Abdullah 2015]. According to Manan and Abdullah [2015], 75.8% of the surveyed enterprises utilized their own funds to start their businesses. Similarly, for working capital for on-going business, Manan and Abdullah [2015] states that SMEs prefer internal sources comprised of personal or family savings and retained earnings to external financing from financial institutions.

Shahadan and Berma [2004] also state that the first preferred source of borrowing for SMEs is not formal finance, such as commercial bank loans, but their own capital or family members' funds, both for starting and continuing their business in Malaysia, regardless of differences in ethnicity.

This survey shows that this is not the case, given the trend seen in Malaysian borrowing through Ar-Rahnu. If the hypothesis on financing by SMEs was correct, business should have already exhausted borrowing from internal funds before using Ar-Rahnu, as a method of debt financing, since the hypothesis predicts that SMEs prefer internal funds to external funds. However, the results of this survey are not consistent with this hypothesis. Most customers who borrow from Ar-Rahnu for business capital answered that they would finance from internal funds if they could not finance from Ar-Rahnu. In other words, Ar-Rahnu comes before internal financing in customers' preferences. This order is contrary to that of the

hypothesis. Therefore, this study finds that Ar-Rahnu is the preferred financing method of SMEs in Malaysia.

VII Conclusion

The results and discussion show that Ar-Rahnu has varied significance in the borrowing culture and credit system in Malaysia. The following discoveries lead to better understanding of the culture and system more.

First, it can be presumed that although the role of Ar-Rahnu is seen as financing for consumption or productive activities, the roles of Ar-Rahnu differ from region to region in Malaysia.

Second, this study reveals that Ar-Rahnu is not significant as an alternative to pawnshops, but that it is an alternative to internal funds. Some previous studies on the consequences of Ar-Rahnu loans have focused on this product's advantages compared with those of pawnshops. However, this study demonstrates the impact of Ar-Rahnu as an alternative to internal funds.

Third, Ar-Rahnu has critical significance for the Malaysian credit system in that this product changes borrowing preferences for SMEs' financing. Taking previous research about SMEs' borrowing preferences in Malaysia into account, it is remarkable that many Ar-Rahnu customers would prefer to borrow from friends or family members without this product, especially in Kota Bharu. It is hoped that the change in revealed preferences for financing of SMEs found in this study will contribute to a better understanding of contribution of Islamic financial products to the real economy.

In considering this reversal in preferences, as indicated in the procedure for Ar-Rahnu, customers must bring their own items to obtain a loan. It is possible that Ar-Rahnu may play a role by functioning as self-financing making it a form of quasi-self-finance. Therefore, it could be that the aspect of Ar-Rahnu as a form of quasi-self-finance causes its significance, despite the fact that it is actually a method of debt financing.

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