

**DETERMINANTS OF REPAYMENT BEHAVIOUR  
IN ISLAMIC MICROFINANCING: THE CASE OF  
RURAL ECONOMY FUNDING SCHEME**

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**by**

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## **LIST OF ABBREVIATIONS**

MFIs	Microfinance Institutions
SMEs	Small and Medium Enterprises
BKRM	Bank Kerjasama Rakyat Malaysia Berhad
NPLs	Non-Performance Loans
NGOs	Non-governmental organisations
TEKUN	Tabung Ekonomi Kumpulan Usahawan Niaga
MARA	Majlis Amanah Rakyat
BSN	Bank Simpanan Nasional
YUM	Yayasan Usaha Maju
SEM	Structural Equation Modelling
PLS	Partial Least Squares
SSM	Suruhanjaya Syarikat Malaysia
SPED	Skim Pembiayaan Ekonomi Desa

**PENENTU TINGKAHLAKU PEMBAYARAN SEMULA PEMBIAYAAN  
MIKRO KREDIT ISLAM: KES SKIM PEMBIAYAAN EKONOMI DESA**

**ABSTRAK**

Pinjaman tidak berbayar (NPL) yang tinggi yang ditanggung oleh institusi kewangan mikro merupakan salah satu faktor yang menyumbang kepada kegagalan untuk mencapai matlamat pengurangan kemiskinan. Oleh itu, kajian ini cuba untuk mengenal pasti penentu tingkah laku pembayaran balik melalui program kewangan mikro Islam di Malaysia. Berdasarkan teori peneguhan yang disokong oleh teori tingkah laku dan teori maklumat asimetri, serta kajian terdahulu yang mempunyai kaitan, 5 hipotesis telah dibentuk dalam kajian ini. Hasil analisis menunjukkan bahawa tingkah laku pembayaran balik peminjam dipengaruhi oleh ciri peminjam dan kebertanggungjawaban mereka. Selain itu, keagamaan dan prestasi perniagaan tidak mempunyai hubungan langsung yang signifikan dengan tingkah laku pembayaran balik. Penyelidikan ini juga mendapati bahawa akauntabiliti memainkan peranan positif yang signifikan sebagai perantara antara ciri peminjam (kekuatan kewangan, keagamaan, pemahaman kontrak, dan prestasi perniagaan) dan tingkah laku pembayaran balik. Seterusnya, kualiti perkhidmatan pelanggan tidak menyederhanakan hubungan antara ciri peminjam dan akauntabiliti. Akhirnya, hasil daripada kajian ini diharapkan dapat memberi sumbangan yang signifikan terhadap pengetahuan program pembiayaan mikro, di mana ianya dapat menjelaskan bahawa prestasi pembayaran balik memainkan peranan yang penting dalam memastikan institusi kewangan mikro dapat terus menyediakan produk pembiayaan mikro kepada pengusaha mikro dan sekaligus membantu meningkatkan ekonomi sosial dan mengurangkan kemiskinan.

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**ABSTRACT**

The high non-performing loans (NPLs) incurred by microfinance institutions is one of the contributing factors for the failure in achieving the goal of poverty alleviation. Hence, this study attempted to identify the determinant of repayment behaviour from Islamic microfinance programmes in Malaysia. Based on theory of reinforcement which was supported by the theory of behaviour and asymmetric information theory, as well as past related studies, 5 hypotheses were established in this study. The results of the analysis showed that borrowers' repayment behaviour were affected by their characteristics and accountability. Moreover, religiosity and business performance did not have a significant direct relationship with repayment behaviour. This research also found that accountability played a significant positive role as a mediator between borrower characteristic (financial strength, religiosity, understanding contract, and business performance) and repayment behaviour. Moreover, customer service quality did not moderate the relationship between borrower characteristic and accountability. Finally, the results are expected to significantly contribute to the knowledge of microfinance programme, of which it explains that repayment performance plays an important role in ensuring that microfinance institutions can continue providing microfinance products to micro entrepreneurs and simultaneously help to improve the social economy and alleviate poverty.

# **CHAPTER 1**

## **INTRODUCTION**

### **1.1 Introduction**

This chapter provides the outline of the study. This study is primarily concerned with borrowers' behaviour in the context of microfinance financing repayment by exploring the antecedents of accountability as the mediator and customer service quality as the moderator in order to understand their impact on repayment behaviour and how such factors were integrated into one model. Besides, the theory of reinforcement was adopted as the main theory to understand the roles of reward and punishment in order to look at how these roles can shape people's behaviour in financing repayment performance. In addition, the theories of reinforcement, behaviour and asymmetric information were used to support the study's model. The problem of repayment was highlighted as a discussion topic in this study and the factors that influence the repayment behaviour were determined. This paper is arranged into six chapters. Chapter One provides the introduction, which includes the background of the study, research motivation, an overview, problem statement, research objectives, research questions, the significance of the study, and research structure.

### **1.2 Background of the Study**

In Malaysia, the microfinance facility is nothing new and it has already been promoted since 1987. It has played an effective role in fighting poverty. Hence, it has successfully been gaining broader attention among policy makers, governments, donors, researchers and scholars across the world (Abdamia & Ibrahim, 2019). Microfinance refers to the provision of financial service concentrating on the very poor, who often are from the low income group and are self-employed (Idama, 2014; Otero, 1999). Sinha

(1998) defined microcredit as small loans, whereas microfinance involves the provision of financial services by non-governmental organisations (NGOs) and micro finance institutions (MFIs), which include financing, saving, insurance, and other financial dealings. Thus, microcredit is a subset of microfinance, as microfinance encompasses the provision of credit financing for the low income group as well as non-credit financial products including savings, insurance, pensions, and payment services (Idama, 2014).

To eradicate poverty, the microfinance system has been aiding the poorest people from having to provide the capital such as for a start-up or an expansion of the business. In addition, some financial institutions have provided training and advice so that the micro entrepreneurs can improve their skills especially in management and marketing and that is what the poor people needed (Kasali et al., 2016). Hence, it has helped the poor to increase the level of income and assets of rural entrepreneur. According to Khandker, (2005) it was found that microfinance's impact is not only in improving a borrower's life but also in boosting local economy.

Further understanding about microfinance, there are two financing mechanisms are offered, namely group-based and individual-based lendings. Group-based lending refers to the financing offered to a group of entrepreneurs comprising several individuals who carry out different business activities. It is also known as joint-liability financing whereby all members of the group share the same liabilities and are involved in similar litigation (Galindo et al., 2015; Kodongo & Kendi, 2013). Meanwhile, individual-based lending is typically used for slightly larger loan sizes as compared to the group-based approach. In addition, individual loans may require one or two guarantors, depending on business performance. Liability and risks are borne by the individuals (Kodongo & Kendi, 2013; Maiangwa, 2012).

Even though the main purpose of microfinance is poverty alleviation, previous research works have documented mixed results regarding its effectiveness in reducing

poverty. They found divergent findings, namely positive, negative, and no impact on poverty alleviation (Samer et al., 2015). Therefore, various factors have been investigated to explain the phenomenon, such as risk management, collaterals, performance issues, payment delinquency, and challenges. The high non-performance loans (NPLs) faced by micro finance institutions (MFIs) has been found as one of the factors that contributes to the failure of microfinance in achieving its main objective, which is to reduce poverty (Shu-Teng et al., 2015). In fact, poor loan collection in major rural credit schemes has caused heavy losses (Bichanga & Aseyo, 2013). The prevalence of NPLs in Malaysia has shown an increasing trend over the years (Chong et al., 2010; Nawai, 2013; Nawai & Shariff, 2012; Shu-Teng et al., 2015b). Table 1.1 illustrate this statement.

Previous studies on microfinance repayment performance were mostly focused on group-based lending because it represents a major part of the microfinancing activities. Meanwhile, Besley and Coate (1995), Ghatak and Guinnane (1999), and Silwal (2003) had conducted research on financing repayment performance for individual-based lending. According to Maiangwa (2012), individual-based lending is riskier as compared to group-based lending with regard to repayment performance. One of the documented risks is the ability to make payment because usually the amount of financing offered for individual-based lending is higher than for group-based lending. In addition, Maiangwa (2012) and Shu-Teng et al. (2015) stated that individual-based lendings are exposed to the deficiency of loan information and the problem of loan monitoring by financial institutions.

In Malaysia, most of the financial institutions offer individual-based lending which records a higher percentage as compared to group-based lending. The lack of enforcement from group members contributes to the repayment issues for microfinance products. This is supported by Ghatak and Guinnane (1999), which highlighted the rule



of peer pressure or social capital as providing enforcement by group members. This study selected Bank Rakyat and SME bank as a sample for the study because the bank has recorded one of the highest percentages of non-performing loans (NPLs) compared to other institutions. Also, the products offered by Bank Rakyat and SME bank are related to the subsidiaries and individual lending approach, which has emerged as a serious issue under repayment performance. For the data collection, this study selected borrowers who reside in rural areas. Questionnaires were randomly distributed to gain feedback from the borrowers. The selection criterion of the sample is the borrowers who are engaged in micro- and small-sized business activities.

This study will provide new insights on the repayment performance of individual-based loans under the microfinancing schemes in Malaysia. In particular, the present research will ascertain the factors that contribute to repayment among microfinance borrowers by applying the theory of reinforcement, and asymmetric information. Elements of accountability and customer service quality are explored as antecedents in the context of repayment performance. According to Walker (2002), accountability plays an important role in the repayment of microfinance borrowers. A person who has higher accountability is always responsible for what he or she does as well as the duties that have been agreed upon and accepted. He or she must be able to fulfil the obligations satisfactorily. Meanwhile, customer service refers to extending services to customers before, during, and after any transaction. Improving the quality of service is important for maintaining customer loyalty and relationships (Ravichandran, 2010). In addition, quality service can improve customer satisfaction in any concern in order to maximise the enjoyment of customer experience and minimise or eliminate unpleasant customer experience.

This study selected Malaysia as the research location. As mentioned in previous literature, Malaysia has been successful in implementing the microfinance programme,

which involves a wide range of institutions from credit unions and cooperatives to non-government organisations (NGOs), government agencies, private companies, and commercial banks. Some of the well-known institutions that offer microfinance facilities are Amanah Ikhtiar, Tabung Ekonomi Kumpulan Usaha Niaga (TEKUN), Majlis Amanah Rakyat (MARA), Bank Simpanan Nasional (BSN), Small and Medium Enterprise Corporation (SME Corp), Yayasan Usaha Maju (YUM), and Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat) (Shu-Teng et al., 2015a). Since 2015, loan repayment problem has been highlighted as a serious issue occurring in all institutions (Shu-Teng et al., 2015b; SME Corp Malaysia, 2017; The World Bank, 2017b). Referring to Table 1.2 in problem statement discussion, the groups that require further investigation on the repayment are individual-based lending customers and subsidiaries because both of these groups recorded higher percentages of non-repayment and have also been criticised in previous literature (Morduch, 2006; Robinson, 2001; Suraya Hanim Mokhtar & Gan, 2012).

### 1.3 Research Motivation

As per report by Bank Rakyat's officers who are in charge for SPED and microfinance product, the number of NLF showed uptrend from 2012 till 2015. Even though the product facility offered many benefits to borrowers such as a rebate of 30%, grace period and lower profit, the number of NPF still showed an increase. Furthermore, various factors have affected household spending due to shirking economies, implementation of taxes, and the increase of inflection point and hence, it will reduce a borrower's commitment to settle the debt. This problem is in line with previous study which documented that the objective of microfinance did not meet the expectation and mixed results were found. Further analysis was made and the issues of repayment contribute to the serious factors in influencing the stability of borrowers themselves and

the financial institution. For example, a borrower can continue to receive facility from bank or other financial institution if no restriction is imposed to them such as being blacklisted, bankruptcy or any legal action taken against them. Besides, the prompt payment can also help other entrepreneurs to receive facility because of the financing cycle<sup>1</sup>. For financial institution, the prompt payment will reduce the account receivable and also the operating cash flow. Hence, the motivation of this study is to find out the repayment behaviour among the microfinance borrowers. The awareness on a good repayment record will help to improve borrowers' social economy and eliminate poverty (Shu-Teng et al., 2015).

An in-depth literature review of repayment behaviour was carried out to identify the gap between knowledge and the issues facing the borrower. Previous literature on repayment behaviour issues especially under Islamic microfinance is still scarce. Furthermore, the literature pointed out numerous issues facing the borrower such as mismanagement, weak governance, breach of trust, lack of religious knowledge, and asymmetric information (Mirpourian et al., 2016; S. Nawai, 2013; Shu-Teng et al., 2015b).

Based on the economic trends worldwide and in Malaysia, the trends have shown a decline (Statista.com, 2019; Theedgemarkets, 2019). In addition, Malaysia has been recording a higher percentage of debt (SME Corp Malaysia, 2017). This factor gives an early signal regarding the collection risk in the future. Drastic actions and the identification of potential factors influencing repayment behaviour need to be emphasised. In addition, household spending has shown an increasing trend due to the new tax implemented.

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<sup>1</sup> Financial institution generate profit from financing (principle and profit). The profit will be used as capital to be given to new borrower. To ensure the profit from financing, the borrower must make prompt payment. Delayed payment will incur with additional cost which affects profit margin.

Therefore, this present study focused on repayment behaviour as the main issue and further sought to examine the potential factors influencing borrowers' repayment behaviour. The borrowers under microfinance facilities were selected as sample because of the high risk involved compared to other debts. It is known that microfinance facilities do not have any collateral and most of the borrowers do not meet banks' financing requirements. In this regard, microfinance facilities have the potential to expose financial institutions to the problem of repayment or collection.

In conclusion, an empirical study on the repayment behaviour for microfinance facilities should be conducted. To identify the possible factors that influence repayment behaviour, relevant theories and previous empirical findings must be referred to. To investigate the possible factors, several theories such as the reinforcement, behaviour, and asymmetric information theories were discussed. In this current study, main source of the research was literature related with repayment behaviour and performance among the microfinance borrowers such as stated in a study by (Nawai, 2014; Shu-Teng et al., 2015b; Mokhtar & Gan, 2012).

#### 1.4 Problem Statement

The main problem of this study was why microfinance facility has yet to meet the objective. Previous study found divergent results such as positive, negative even no effect of microfinance programmers. The high level of non-performing loans (NPLs) incurred by micro finance institutions is one of the contributing factors to the failure in achieving the goal of poverty reduction. Hence, the main issue discussed was the problem of loan repayment regarding Islamic microfinance products in Malaysia based on an individual's lending approach. The scope of the study focused on rural entrepreneurs which refer to those who are in the category of micro enterprise (having revenue less than RM300.000 per year, as indicated in Table 1.1). Most of the

entrepreneurs have average income within the range of RM20,000 to RM150,000. The income has been fluctuating depending on demand, weather, supplier pricing and the opening of uncertain business environment. According to Kasali et al., (2016) and Satti & Ahmad, (2018) micro entrepreneurs' backgrounds are usually involved with small scale and their sole source of income comes from business. It is riskier to them if something happens with their business as it can affect their household income which ultimately may impoverish them. Hence, the involved financial institution has to be aware on financing them because it is more risky compared to financing those who have fixed income such as government servants and those who receive income on monthly basis from employers. In regards to this matter, researchers have long discussed the loan repayment issues in microfinance. Most of the previous studies argued that repayment performance is an important factor to enable the MFIs and micro entrepreneur to operate in a sustainable manner (Godquin, 2004a; N.Shariff, 2012; Shu-Teng et al., 2015b; Mokhtar & Gan, 2012).

Furthermore, the previous studies have criticised the subsidised microfinance system, which recorded high default rates (Morduch, 2006; Robinson, 2001). This statement has been confirmed by Mokhtar et al., (2012), who documented that repayment performances in several MFIs in Malaysia, especially under the subsidised system, have not been satisfactory. Thus, to illustrate this argument, some of the data from previous studies were used to compare the repayment performance rates of microfinance facilities in Malaysia (as displayed in Table 1-1).

Table 1.1: The Prevalence of Non-Performing Loans/Financing (NPL/NPF) for Microfinance Products in Malaysia

FINANCIAL INSTITUTIONS	RATE OF NON-PERFORMANCE LOANS (NPL)	PRODUCT/FACILITIES APPROACH	SYARIAH COMPLIANCE
<b>Government Agencies</b>			
TEKUN Nasional	37.82%	Subsidiary	YES
Yayasan Usahawan Malaysia (YUM)	9.28%	Subsidiary	NO
Amanah Ikhtiar Malaysia (AIM)	1.5%	Subsidiary	NO
Permodalan Usahawan Nasional Berhad (PUNB)	6.35%	Subsidiary	NO
Cooperative Commission of Malaysia (CCM)	13.8%	Subsidiary	NO
<b>Government Linked Companies (GLC)</b>			
Perbadanan Nasional Berhad (PNB)	1.76%	Subsidiary	NO
Bank Rakyat	72.04%	Subsidiary	YES
SME Bank	36.39%	Subsidiary	MIXED
<b>Commercial Banks</b>			
Public Bank, CIMB, Maybank	Between 0.95%–3.15%	Own facilities	NO

Sources: (Berita Harian, 2018; Bernama, 2018; KKLW 2019; PNB, 2018; Shu-Teng et al., 2015a; Sun, 2018;)

Table 1-2 shows the prevalence of loans defaults for the three main categories of microfinance providers in Malaysia, namely government agencies, government-linked companies (GLCs), and commercial banks from 2009 to 2015. The government agencies, which are the Cooperative Commission of Malaysia (CCM) and Perbadanan Nasional Berhad (PNB), recorded NPLs of 13.8% and 1.76% respectively. Higher percentages of NPLs were reported by TEKUN Nasional, Yayasan Usahawan Malaysia (YUM) and Permodalan Usahawan Nasional Berhad (PUNB), at 37.82%, 9.28% and 6.35% respectively. Meanwhile, the commercial banks, namely Public Bank Berhad, CIMB Bank Berhad, and Malayan Banking Berhad (Maybank) recorded NPLs within the range of 0.95% to 3.15%. Under the GLC category, Bank Rakyat and SME bank recorded higher NPF of 72.04% and 36.39% in 2019. This percentage is worse than the percentages recorded by the government agencies and commercial banks. However,

Bank Rakyat and SME bank provide products based on subsidiaries approach, which has occurred as a serious issue under repayment performance. Therefore, the selection of Bank Rakyat and SME bank as the sample for this study was expected to reveal more significant findings in relation to the causes of the NPL problem as compared to other institutions.

In addition, the World Bank Group (2017) reported that Malaysian financial institutions had recorded the highest debts in the world. In 2014, 56% of Malaysian adults had bank loans, which was the highest percentage recorded worldwide (World Bank Group, 2017a). Apart from that, Malaysia's NPL ratio had increased in September 2017 to 1.7% from 1.6% in 2016 (CEIC, 2017; World Bank Group, 2017a). Among the reasons for the increase in NPL were the weak global growth and economic reforms in the domestic economy such as the rationalisation of subsidies as well as the implementation of minimum wage and goods and services tax (GST). According to Shaharudin et al., (2016), the introduction of GST on 1 April 2015 and depreciation of the Ringgit had resulted in an increase in the cost of living, leading to adjustments in household spending. These circumstances were determined as factors that influence payment behaviour among customers of Islamic retail financing.

The issue of repayment behaviour concerning the Islamic banking industry needs to be emphasised to determine its causes. The objective of Islamic microfinance and Islamic finance is based on the socio-cultural foundation which is aimed at financial inclusion and risk sharing (Ferro, 2005). On the other hand, conventional microfinance does not fulfil the needs and requirements of many Muslim clients. According to Chapra (2000), conventional financial products are incompatible with *maqasid sharia* (the main objective of Islamic law), which is focused on preserving the wellbeing of the people, namely their faith (*deen*), life (*nafs*), intellect (*'aql*), posterity (*nasl*), and wealth (*maal*).

Conventional finance does not focus on the religion aspect as it is only concerned with generating profits while ensuring that the products adhere to the laws and regulations.

Furthermore, the study conducted by Abdul Rahman and Dean (2013) examined the challenges faced by Islamic microfinance institutions (MFIs) in Malaysia. This study mapped out some suggestions to resolve the issue. One of the solutions suggested was that banks should engage more in microfinance and diversify their portfolios. It was supported by Dusuki (2008) who believed that Islamic Bank needs to have greater involvement in microfinance to meet the financing needs of the economically marginalised society by providing an alternative to channel funds to the poor. Recently, Kachkar and Fares (2015) highlighted the main challenges facing Islamic Banks when dealing with microfinance such as the risk of default, lack of funds, the unwillingness of shareholders to bear the microfinance risk, high overhead and operating costs, the complexity of microfinance processing, lack of well-trained employees, and regulatory restrictions.

Moreover, the issue of borrowers' accountability needs to be emphasised because it may influence repayment behaviour. The issues of transparent "information discloser" will influence financial institution to approve the amount of financing. The impropriated of the financing amount can affect the ability of repayment (Sha'Ven et al., 2015). Besides, the importance of accountability will encourage people to perform the obligation and put efforts in finding solution if they are facing a problem (Lewis, 2006). In terms of repayment, the attitude of "transparent" accountability is an important factor to ensure the financing will be given based on what the business needed. Additionally, an accountable attitude can also encourage borrowers to make payment even though they are facing difficulties. Some of the efforts acknowledged are by requesting advice from financial institution and solving all the problems. Hence,



accountability has been used as mediator to strengthen the relationship between borrower characteristic and repayment behaviour.

Recently, to ensure the customers are always accountable with the financing customer service quality needs to play the role as motivator in order to encourage and advise the borrowers to perform the payment (Mosahab et al., 2010). Lack of quality customer service will result to the customers not being loyal and the bank cannot identify the issues faced by the customers. Some people need motivation and supervision to enforce the responsibility. In this regard, the customer service quality has been used as moderator to support the relationship between borrower characteristic and accountability.

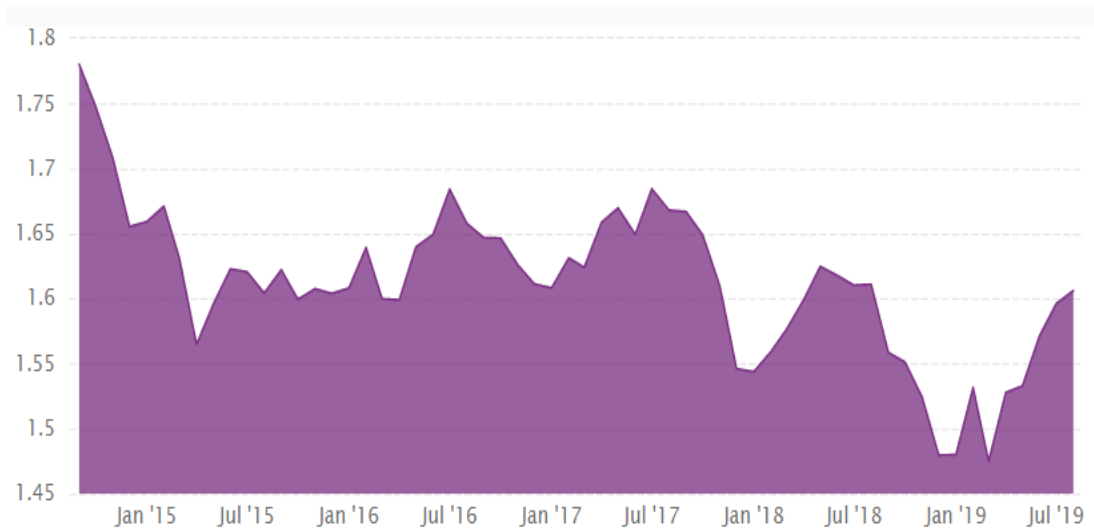
Another issue related to borrowers' repayment behaviour is the implementation of religion in daily life. Recently, the religiosity factor has been highlighted to affect repayment behaviour. According to N. Nawai and Shariff (2012), borrowers who have knowledge of formal religious education are more responsible and accountable in repaying their loans because in Islam, paying debts is necessary and an obligation even after the borrowers' deaths. In addition, Kamaluddin (2015) found that religiosity represents another important component to be investigated under the repayment behaviour. This study used the element of social collateral as one of the Islamic banking models. Besides, most of the respondents agreed that the element of religiosity is important that it needs to be considered when it comes to discussing the effectiveness of Islamic microfinance repayment.

Furthermore, Gehrig et al., (2019) supported the argument that an individual who has the knowledge and applies the religious requirements is less likely to make a late payment. Rulindo and Mardhatillah (2011) mentioned that religiosity plays an important role in enhancing microentrepreneurs' performance in the economy. Similarly, Said,

Alam, and Salwana (2015) demonstrated the importance of being religious in association with entrepreneurial activity for the purpose of economic growth, particularly for Islamic microfinance borrowers. In addition, Zeller (2015) and Alshelfan (2014) concluded that Muslims ought to conduct their business activities in accordance to the requirements of Islam, which are by being fair, honest, and just towards others. While most people realise that religiosity could shape behaviour (Abou-Youssef et al., & El-Bassiouny, 2015; Khraim, 2010), no study has investigated on how the religiosity element specifically plays an important role in influencing borrowers' loan repayment behaviour.

Besides, the issues of transparency, corporate governance, and accountability have been discussed together with the issues of political decision making and NPLs. This is because under the financial liberalisation in developing countries in recent years, these issues have been given serious attention to help reduce the impact of political decision-making on the functioning of financial institutions and also to reduce the prevalence of NPLs. In line with efforts to reduce political bureaucracy involving NPL issues, the impact of accountability needs to be examined as an indicator to reduce the problem. The issue was discussed by Aaron et al., (2013) by focusing on operations. They mentioned a good system of accountability and transparency in operations could contribute in promoting ethical values.

Lastly, in the year 2019, the trend of NPL was recorded to have increased with NPL ratio at 1.53% in January 2019 compared to 1.61% in July 2019. Increased NPL percentage will reflect the health of banking system and eventually affect the loan cycle. Besides, difficulties in collecting it will affect the profit or interest and the principle on the loan. The statistics of the NPL performance is as follows.



Sources: (CEIC, 2019)

Figure 1.1: Statistics of Non-Performing Loan (NPL)

Therefore, the factors of higher percentage of NPL which are the implementation of additional tax, higher debt, subsidiaries problem, unstable Malaysia currency and shrinking economies should serve as early indicators for financial institutions to be more alert of potential repayment problems in the future. For entrepreneurs, they must be able to identify the causes of these problems so that they can be more cautious and prepared. Thus, it is expected that this study would identify the factors that cause the occurrence of the repayment problem and ascertain the factors influencing borrowers' accountability

### 1.5 Research Questions

In view of the explanation given in the problem statement and objectives of the study, the following research questions have been formulated:

1. Does borrower characteristic significantly has the relationship with repayment ?
2. Does borrower characteristic significantly has the relationship with the level of accountability?

3. Does the level of accountability significantly has the relationship with repayment ?
4. Does the level of accountability mediate the relationship between borrower characteristic and repayment ?
5. Does customer service quality effectively moderate the relationship between borrower characteristic and level of accountability?

#### 1.6 Research Objectives

This research is intended to extend on the work in the previous literature by focusing on the determinants of repayment for the microfinance products. Therefore, five objectives have been formulated as follow:

1. To examine the relationship between borrower characteristic and repayment .
2. To examine the relationship between borrower characteristic and the level of accountability.
3. To examine the relationship between the level of accountability and repayment .
4. To examine the influence level of accountability as a mediator in the relationship between borrower characteristic and repayment .
5. To examine the effect of customer service quality as a moderator in the relationship between borrower characteristic and the level of accountability.

#### 1.7 Significance of the Study

This study is expected to expand the breadth and depth of knowledge regarding the determinants of microfinance repayment performance. Besides, the study is expected to distinguish between the theoretical aspect and practical perspective to bring new

insights in order to identify the real factors that influence borrowers' repayment behaviour. Therefore, the explanation of these two aspects is elaborated below:

### *1.7.1 Theoretical Perspective*

Generally, from the theoretical aspect, it is expected that this study will fill the knowledge gap with regards to gaining commitment from borrowers and financial institutions based on accountability and customer service quality as antecedents. The issue of loan repayment problems is debated based on the review of the literature. However, in Malaysia, there is a scarce literature focusing on Islamic microfinance, particularly from the aspect of bank borrowers as the sample. As opposed to the previous studies, the selection of banking institutions in measuring the default in repayments is expected to provide a robust result because the banks are fully supervised by Bank Negara Malaysia (BNM) and restricted by the banking regulations. Hence, it is intended that this research will contribute additional information with the aim of improving loan repayment.

To the best of the researcher's knowledge, this is the first time the theory of reinforcement was thoroughly and rigorously tested based on an internal factor of repayment behaviour among microfinance borrowers. The theory of reinforcement explains about the consequences that will be imposed to those who go against the rule while those who perform the obligation will be rewarded. Hence, the chosen variable must be related to both positive reward and negative punishment. Additionally, the contribution of the combination of theory of reinforcement, theory of behaviour and theory of asymmetric information was discussed in the perspective of repayment behaviour. Therefore, this study has developed a comprehensive theoretical framework to examine and understanding the factors influencing repayment behaviour. Thus, this

theory can play a role in terms of alerting the lender and the borrower to perform properly so that both will get benefits (Bandura, 1974; Viken & Mcfall, 1994).

### *1.7.2 Practical Perspective*

From a practical perspective, it is crucial for the financial institutions to understand the factors that affect loan repayment. This information can mitigate the course of offering financing to the unqualified borrowers which are potentially going to be involved with default payment. In line with previous study, the financial institutions may not have sufficient funds to maintain their liquidity position because of the higher NPL (code). Consequently, there might be disruptions in the cyclical flow of funds between the financial institutions and the borrowers. Accordingly, the results of this study may provide information to the financial institutions and the borrowers about the causes of loan defaults. Moreover, it can be applied as one of the instruments to measure the eligibility of a customer for financing and can improve the internal factors such as customer service quality and work ethic so that it can encourage borrowers to become accountable.

Furthermore, in the borrowers' perspective, the expected result can give information regarding the issues involved in loan repayment performance based on actual problems. Most of the previous studies focused on the institutional perspective and blamed the borrower without investigating properly the issues faced by the borrower. Additionally, for the spiritual of borrower to become a good borrower based on the element of religiosity has been examined. The selection of religiosity as an independent variable is expected to contribute information to borrowers and lenders about the importance of religion in financing dealing and also to understand the important of being accountable and honest.

As mentioned by Abou-Youssef et al. (2015), the role of religiosity can cause a person to do good deeds and bring him/her away from a bad attitude and dishonesty. To the best of the researcher's knowledge, this is the first time the variable of religiosity was used as the determinant of repayment behaviour in an Islamic microfinance study. Most of the previous studies used the religiosity element to understand the people's beliefs, consumer attitude, and the relationship between human and the Creator (Abou-Youssef et al., 2015; Khraim, 2010; Rehman & Shabbir, 2010). Moreover, there is a strong relationship between religiosity and the theory of reinforcement, which has been proven by Khraim (2010), who mentioned that people would learn if it is related to them and the guidance of rewards and punishments can motivate people to avoid harm.

Furthermore, this study is expected to contribute to the policymakers in improving the microfinance facility. According to Massele, Fengju, and Masele (2015), the government of Malaysia has designed national policies and plans to manage resources allocation more effectively so that sustainable development and national goals are attained. The main aims in developing economies are to ensure the welfare of the people is taken care of and alleviate poverty. In Malaysia, the policymakers recognise the importance of microfinance in achieving socioeconomic growth towards developing the country (Nawai, 2014). In this regard, the government of Malaysia has established many institutions to deliver financial and non-financial services in assisting the people who live in poverty and are restricted from accessing formal financial services.

Recently, most of the scholars and researchers from various backgrounds have identified the importance of the loan terms to the borrower performance such as loan size, loan period, repayment flexibility, and interest rates (Massele et al., 2015). The beneficiaries especially the poor who face a high level of risk and those who lack the capability of managing their loans expect the repayment policy to help them. According to Al-Shami et al. (2013) and Massele et al., (2015), one method proposed by the

Grameen model is related to flexibility, and rescheduling loan repayment can be considered as the best way to secure the defaulting borrowers and facilitate the opportunity of obtaining a loan.

In conclusion, the outcome of this study can help the government as the policymakers make decisions on sustainable programmes and improvements of the microfinance programme in Malaysia in addition to ensuring MFIs can continue to provide microfinance facilities to genuine entrepreneurs. This effort is in line with the New Economic Policy (NEP) that was instituted in 1970 which focuses on poverty eradication (Nawai, 2014). The NEP was launched in 1971 to achieve the socio-economic goals parallel with the economic growth objectives as a way of creating harmony and unity in a nation with many ethnic and religious groups.

### 1.8 Descriptive of Key Terms

Specialised terms used in this study include microfinance, repayment behaviour, borrower characteristic (financial strength, religiosity, contract and business performance), accountability and customer service quality. These terms were adopted for the Malaysian context. In this research, microfinance refers to the provision of financial service concentrating on the very poor, who often are from the low income group and are self-employed (Idama, 2014; Otero, 1999). Repayment behaviour refers to those who make prompt, delinquent and default payment (Shu-Tenget al., 2015). Borrower characteristic are referring to borrowers' behaviour and focus on internal factor. Hence, four characteristics were identified, namely financial strength which refers to the stability of financial condition in terms of capital, cash in hand and bank, liability, and equity (Hasanaj & Kuqi, 2019);s religiosity which refers to the element of understanding the people's beliefs, consumer attitude, and the relationship between human and the Creator (Abou-Youssef et al., 2015; Khraim, 2010; Rehman & Shabbir, 2010); contract refers



to two parties who impose conditions in the agreement Sharpe (1990), while business performance refers to organisational performance, financial performance, operational performance, and intellectual performance (Achim & Borlea, 2013). Besides, two variables for antecedent were imposed such as accountability and customer service quality. According to Lewis, (2006) accountability refers to attitude of obligate and fulfil the responsibility and customer service quality refers to providing information together with advice and action (Mosahab, Rahim, Osman Mahamad, 2010).

## 1.9 Thesis Structure

### *Chapter One*

This thesis comprises four chapters. Chapter one discussed and presented the summary of the entire study. This chapter began with an introduction and followed by the background of the study, problem statement, research objectives, research questions, and the significance of the study. This chapter attempts to lead the reader to understand the basis for the discussion of this study so that the issues discussed are more focused and clearer.

### *Chapter Two*

This chapter is composed of five main sections that provide a comprehensive review of the literature. The first section presents the literature review focusing on the empirical studies related to loan repayment of microfinance products. The issues of repayment in the global and Malaysian markets are discussed intensively, narrowing down to the factors that influence repayment. The objective of reviewing the empirical studies is to prove that loan non-repayment is a significant issue that must be highlighted because this topic has been the subject of discussion worldwide as well as in Malaysia. Furthermore, this chapter also discusses the institutional context. This section seeks to provide information and understanding of microfinance products. It further discusses

the role of financial institutions in implementing this programme. Moreover, a detailed description of the definitions, categories, and modus operandi of microfinance in Bank Rakyat and SME bank are discussed.

### ***Chapter Three***

This chapter discusses the development of the conceptual framework based on the correlations among the theoretical background, key concepts, and empirical study. This section discusses the rationale for using the theory of reinforcement and explains the research model. Besides, this section elaborates the process of developing the hypothesis to be tested in this study with the purpose of achieving the aim and objectives and thereby answering the research questions.

### ***Chapter Four***

This chapter deliberates the methodology adopted in this study. It consists of sixteen sections with the purpose of providing a comprehensive review of the research methodology. The research design is discussed to provide the research setting and data collection procedure so that further elaborations will become clearer. It involves identifying the research phases as well as the data collection methods, sampling techniques, and data analysis techniques employed in the study. This chapter also demonstrates the process of developing the measurements scales for the study and presents the pilot test. It further explains the data analysis done in this study, which consists of descriptive analysis, SEM procedure, and reliability and validity analysis for the purpose of data screening.

### ***Chapter Five***

This chapter focuses on the results of the statistical analysis. Specifically, this chapter presents the results of the model measurement assessment, which covers internal consistency reliability, indicator reliability, convergent reliability, and discriminant reliability. This chapter continues with a discussion of the structural conceptual model

measurement by looking at the coefficient determination ( $R$ ), path coefficient, and hypothesis testing for all the variables. In addition, mediating factor analysis and moderating factor analysis are discussed in this chapter to look at the functions and relationships among the selected variables.

### ***Chapter Six***

This final chapter continues with the discussion and explains the implications of the research findings as well as limitations of the present study. Suggestions for future research are presented and finally, a summary of the research findings is discussed

## **CHAPTER 2**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter provides a review of the existing literature related to the microfinance repayment performance and discusses the various views of scholars on all key issues relating to the variables of repayment. This chapter comprises seven main sections. Section 2.2 discusses the loan terminology and it has four subsections to explain details such as types of loan, purpose of loan, secured and unsecured loan, and loan policy. Section 2.3 discusses the definition of default and the repayment terms. In Section 2.4, this study discusses the empirical literature on loan repayment performance. This section has three subsections to discuss the empirical studies on default in other countries as well as in Malaysia and emphasises the factors influencing repayment and default. Section 2.5 discusses the institutional context with a brief explanation of microfinance and detailed discussion about Bank Rakyat and SME bank as a sample for this study. Lastly, Section 2.6 discusses the research gap, and Section 2.7 provides the conclusion.

#### **2.2 Loan and Financing Terminology**

In general, loans involve individuals, groups, organisations, or entities. Normally, a loan is a debt granted by an entity such as an organisation or an individual to another entity by charging interest rates and is bound by a contract of agreement (Woolcock, 2017). Sheilah (2011) defined loans as money lent with interest that must be settled. In other words, the loan refers to a loan for a temporary period and must be returned in equivalent condition. The successful loan is in getting back the financial

rewards as expected by the lender, and the risk that may be encountered is the borrower will not make repayment as predicted.

Hu, Li, and Chiu (2004) described the basic function of the banking sector is to accept funds from the clients as deposits with the purpose of using those funds to provide loans and credit facilities. Added to that, Hand and Henley (1997) mentioned that a loan refers to a type of bank credit, while the comprehensive definition of credit includes all types of lending and it is available as a form of loans. In addition, Collins, Thorp, and White (1999) expressed that credit is like loans which is to fulfil the needs of households, businesses, or the government by banks or other financial intermediaries.

Briefly, Gurdia (2002) mentioned that a loan consists of three parts. The first part is the lender or sometimes called the creditor, which as the provider advances money to the borrower; this is known as the first part of the credit process. The lender can be a banking or a non-banking institution such as a union credit, which is defined as a financial intermediary. The second part is the borrower, which requests money from the lender with a binding promise to pay for expenses and services. Usually, the borrower is in the form of an institution or a person who has a shortfall in funding. The third part of the credit process is the agreement between the lender and the borrower. It consists of a loan agreement or a legal contract for the purpose of insuring the rights of both the creditor and the borrower.

From the Islamic perspective, Islamic banking and finance is built on the principles of the prohibition of *Riba* ' (interest) and compliance with the Shariah (Islamic law) requirements (Abedifar et al., 2015). Abozaid and Dusuki (2007) mentioned that the lent amount must be returned without any profit since the primary goal of Islamic finance is profit-loss-sharing (PLS) and social justice along with economic prosperity.

Moreover, there are several types of financing in Malaysia such as personal financing, business financing, mortgages, and hire purchase financing. Usually, the