

**CHAPTER 2**  
**UNDERPINNING THEORIES OF ISLAMIC BANKING**  
**(SUPPLY-SIDE)**

**2.1 Overview**

This chapter discusses on the philosophical underpinnings of Islamic banking, starting with an overview of chapter in section one. Section two discusses the evolution and performance of Islamic banking. Section three discusses the guidelines of BNM. Section four and five entails the general theory of Islamic banking and the Islamic financing facilities in Islamic banking system which comprises of discussions on human needs for financing facilities, sale-based financing (SBF) and equity-based financing (EBF) contracts respectively. Section six discusses the history and development of EBF contracts. Next is the discussion empirical studies are under section seven. Section eight presents the contribution of knowledge regarding empirical studies and lastly, section nine concludes this chapter.

**2.2 Evolution and Performance of Islamic Banking**

In the early days of Islam, *Baitul Mal* is the first organized Islamic financial institutions and was known as “House of Money” (Ansari, 2013). The main functions of *Baitul Mal* are as taxes administration, distribution of *Zakat* and managing government expenditures (Ansari, 2013; Sadr, 2016).

Saidina Umar Al-Khatib who was first established the *Baitul Mal* as there was a large increase in state revenue from the concord territories that needed to be

managed. Besides, he also introduced the allowance to non-Muslim and relief from *Jizyah*. During this time, some banking activities took place in the form of custody of money and precious items and remittances (Ansari, 2013).

Then, the first person introduced Islamic principles of *Qard* or financing was Az-Zubair Al-Awwam. The history started when he refused money from depositors if it was in the form of savings since the person entrusted to keep the deposit would pledge to return the amount deposited. Also, he explained that he preferred it to be in the form of financing since when people came with money to help keep, money must be maintain as financing and not as deposit. His action upholds two (2) purposes. First, he had right to use it if he keep deposit as financing. Second, deposits would actually be a loss to its owners if it was not used (Kettell, 2011; Ansari, 2013).

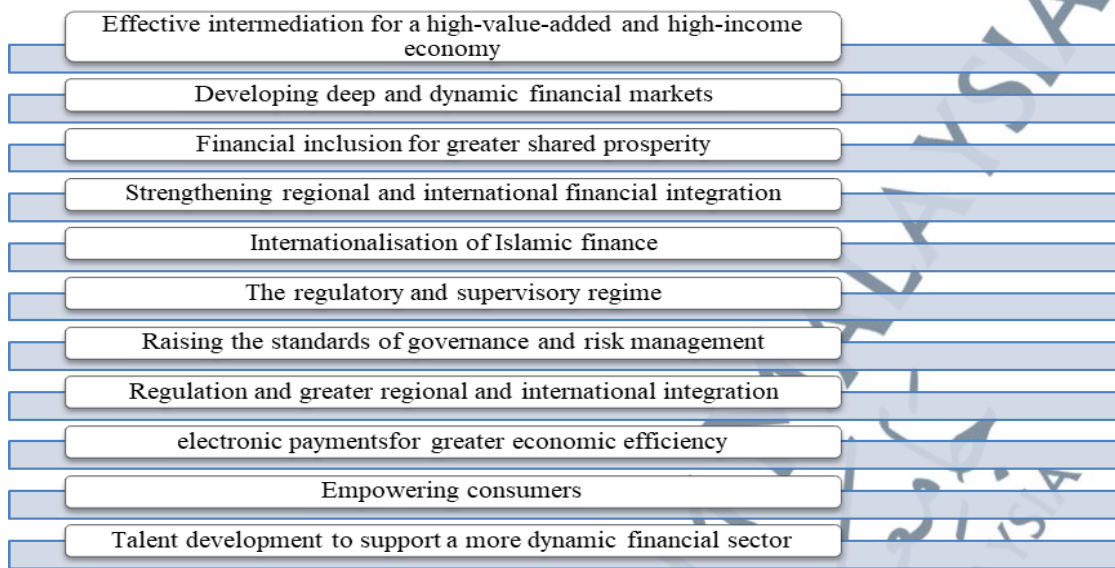
The history of early Islamic banking through the story of Az-Zubair represents the change in the concept of deposit. His son, Abdullah Az-Zubair then he hesitant about distributing his father's assets after death of his father among his siblings even after paying back all of his father's dues (Sadr, 2016). Then Abdullah made announcements urging those who had deposited with his late father to come forward and reclaim their money from him. Despite of that matters, the community of Mecca at that time only knew that the uses of money are first, to entrust money to someone else for it to be used in business based on *Qirad* or *Mudharabah* principle and second, to loan out money in order to get interest (*Riba*).

With the arrivals of Islam, *Riba* activities were no longer permitted with the establishment of Islamic banking system. The financial activities in Islamic banks generate in halal activities, promote profit-and-lost sharing (PLS), quest for justice and sanctify contracts (Ayub, 2007).

The development of Islamic banking in Malaysia has growth year-by-year with first establishment of Lembaga Tabung Haji (LTH) which incorporated in year 1962. Then Bank Islam Malaysia Berhad (BIMB) was established in year 1983. Then in year 1999, Bank Muamalat Malaysia Berhad (BMMB) was established as second Islamic banks. Several of Islamic banking system which includes of Islamic window of finance in Malaysia was established such as Maybank Islamic Berhad, CIMB Islamic Berhad, RHB Islamic Berhad, Affin Islamic Berhad and so forth (Aziz, 2013).

In terms of Islamic products and services, various Islamic financial products and services such as *Murabahah*, *Mudharabah*, *Musharakah*, *Ijarah* and *Bay Bithaman Ajil* are offered among the Islamic banks in Malaysia as they introducing the *Riba*'-free products and services to expand the scope and customer-base (Saat et al., 2011).

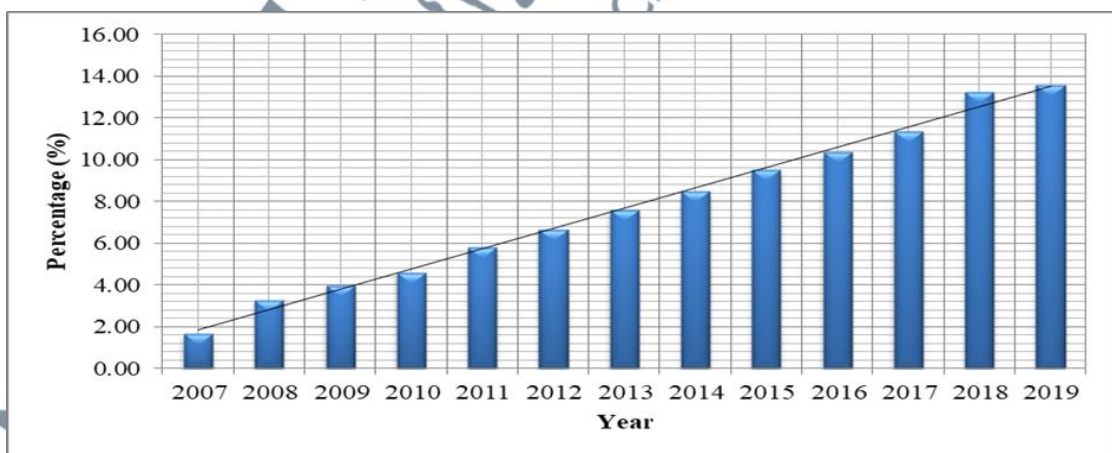
To extent these further, the development of Islamic banking system in Malaysia could be seen from its on-going plans to this end (Aziz, 2013). There are eleven (11) features as stated in the Financial Sector Blueprint 2011-2020 which includes of:-



Source: Bank Negara Malaysia

**Figure 2.1:** Financial Sector Blueprint 2011-2020

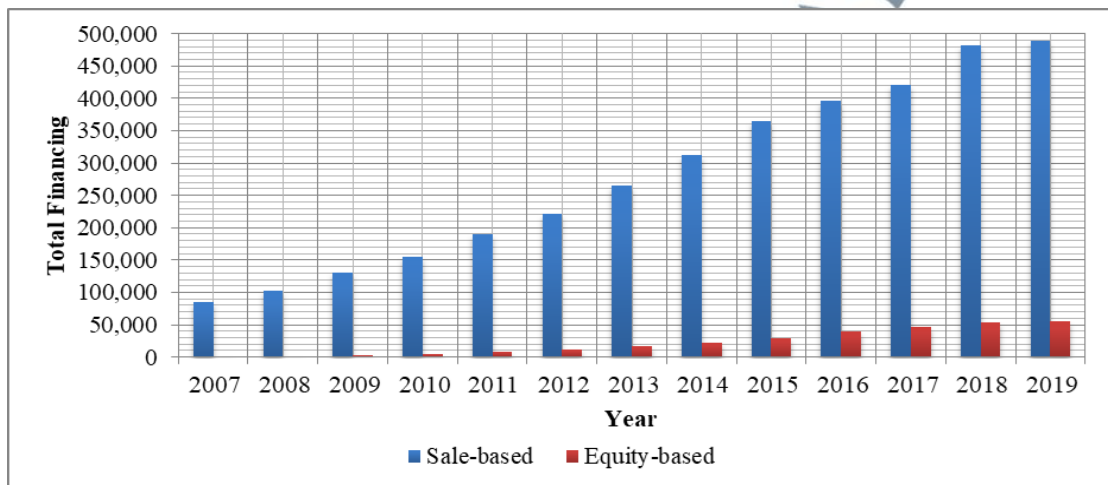
With the development of Islamic banks, presently, there are a total of 16 Islamic banking institutions in Malaysia was established with eleven (11) of local Islamic banks and five (5) of foreign Islamic banks as stated in Bank Negara Malaysia’s website.



Source: Bank Negara Malaysia (2019)

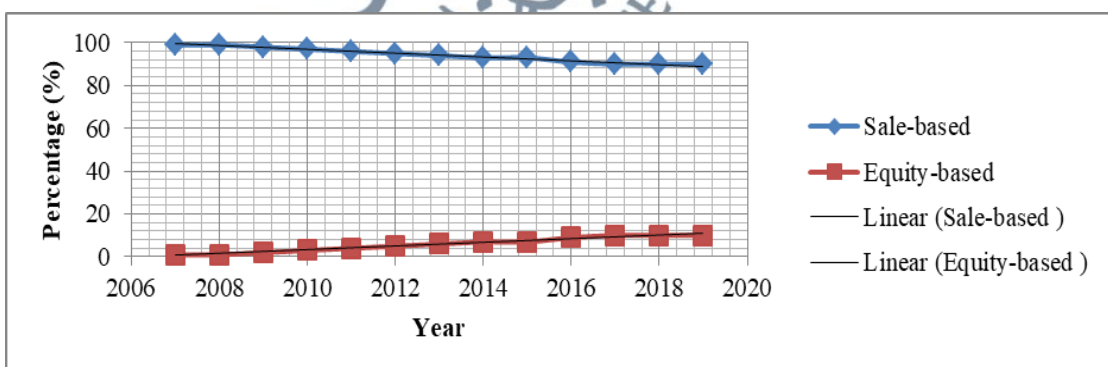
**Figure 2.2:** Trend Performances of Islamic Banking Assets in Malaysia from Year 2007 to 2019

As at middle of 2019, the Islamic banking assets accounted for approximately 13 percent of the total Islamic banking assets in Malaysia compared the past 10 years accounted only 1.9 percent as shown in figure 2.2.



Source: Bank Negara Malaysia (2019)

**Figure 2.3:** Trend Performances of Total Financing of Islamic Banking from Year 2007 to 2019



Source: Bank Negara Malaysia (2019)

**Figure 2.4:** Percentage of Total Financing of Islamic Banking from Year 2007 to 2019

Based on the trend performances of Islamic banking assets in Malaysia, this shows that sale-based financing (SBF) such as *Murabahah*, *Ijarah*, *Bay' Bithaman Ajil*, *Ijarah Thumma Al-Bay'*, *Istisna'* and others contributed high impact within 12 years of performance with increasing marginally with total of RM 404,702 (in million) compared with equity-based financing (EBF) such as *Musharakah* and *Mudharabah* which contributed only increase in numbers of contribution with a total of RM 54,126 (in million) within 12 years of performances as shown in figure 2.3 above.

However, the trend performances for both types of financing in Malaysia are accumulated in a linear trend-line as presented in figure 2.4 above. This shows that these trend performances have consistently risen at a steady rate over a 12-year period. Notice that the percentage of SBF is down in 9 percent and there are an accumulative number of increases for EBF with accounted in 9 percent over a 12-year period, which is a good fit of the line to the data.

Based on the above matters, it shows that the recent report performance of Non-performing Financing (NPF) has reached RM25.1 Million (as year ended 2019) as it impacts not only the credit risks in SBF but the acceptability matters in demand-side since banks more offers SBF rather than EBF in reality (Amin et al.,2015; Abdul Rahman, 2019). The related critique on SBF has led to current study to explore in EBF issues as reasons why they neglect to offers EBF.

Although, even the performances shown the high contribution in SBF impacts the increasing numbers of Islamic banking assets in Malaysia within 12-year period, there are many critiques arises (Amir et al., 2015; Ebrahim & Sheikh, 2016; Fa-Yusuf

& Ndiaye, 2017). One of the critiques is the SBF practice is not a true risk-sharing structure. Critics argue that, in this way, Islamic banking in current practices is not so very different from conventional banking.

Therefore, there is still a potentiality for EBF contracts to grow further for Islamic banking system in Malaysia since these types of financing is renowned as the pure and justice contracts. This potentiality may enhance the financial sector's capability to support high value-added activities. This has stated under the Financial Sector Blueprint 2011-2020 (stated in 2.1.1). There are two (2) important highlight regarding financing which first is to enhance the role of financial institutions in developing PLS investments and financing facilities and second is promote the full range of financing development financial institutions to targeted strategic sectors.

### **2.3 Guidelines of Bank Negara Malaysia (BNM)**

Legal aspects in EBF contracts are one of necessity aspects as it includes of the legality in Basel Accord I, II, III and IV and its implications for Islamic banks in complying these legal in Islamic banking system.

#### **2.3.1 Basel Accord I, II, III and IV**

There are different key aspects among the implementation of Basel Accords. The rule of Basel I was released in year 1988 which providing a paradigm to address risk management from a bank's capital adequacy perspective (Jablecki, 2009). Besides, the focused is in terms of existing assets rather than the future composition of a bank's portfolio.

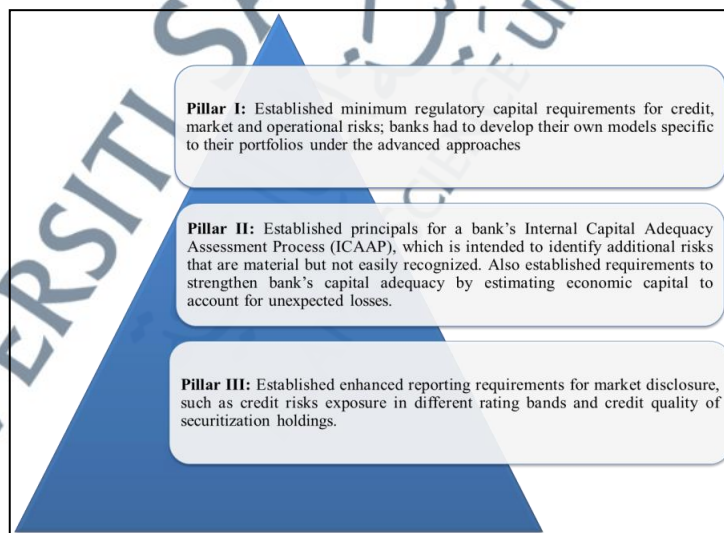
**Table 2.1:** Basel I Risk Metrics

Counterparts	Sovereigns	Banks	Mortgages	Corporate
<b>Risk-Weights</b>	0%	20%	50%	100%

Source: Basel Committee on Banking Supervision (BCBS)

As shown in table 2.1 above, the focus aspect is fixed in terms of predetermined risk-weights for different asset classes. For instance, cash as well as sovereign is 0 percent, banks are accumulated with a total of 20 percent, uninsured residential mortgage loans are 50 percent and for corporate loans is 100 percent.

In terms of assets, there are differentiated assets between banking and trading books. Regarding to risk measurement, there is no advanced measurement of risk under this implementation of Basel I, based upon bank-specific portfolio. In addition, for simple tier calculation, tier 1 capital ratio is 4 percent and total capital ratio is 8 percent (includes of tier 1 and 2).



Source: Basel Committee on Banking Supervision (BCBS)

**Figure 2.5:** Three-Pillar Approach to Risk Management

As shown in figure 2.5 above, Basel II introduced three (3) pillars approach to risk management. It then released in year 2007 with somewhat forward looking on risk-sensitive approach to capital calculation which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision (Garside & Bech, 2003). The Basel is provided smaller banks option of adopting the more risk-sensitive advanced approaches or a less sophisticated standardized approach, which was modeled after Basel I.

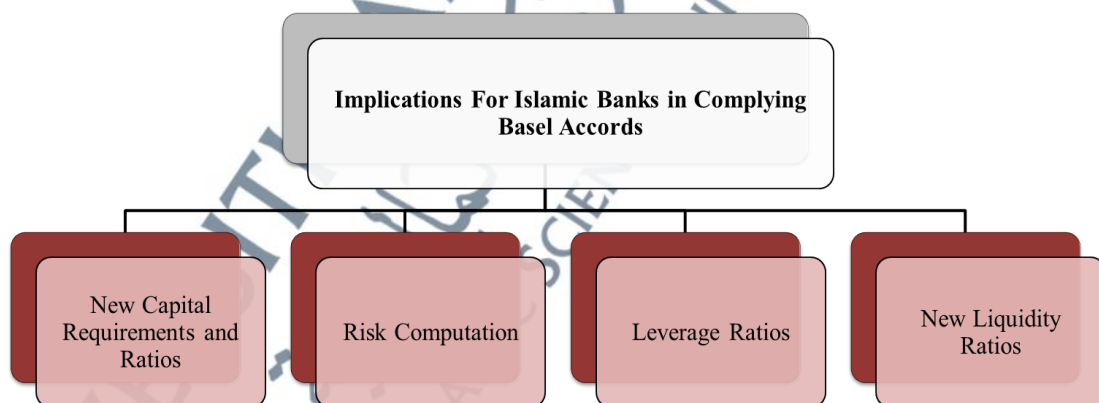
Then, the rule of Basel III was released in July 2013, with phase-in implementation by year 2019. It emphasis on reducing systematic risk by minimizing procyclicality and promoting counter-cyclicality via capital conservation and countercyclical buffers which building up capital in good economic times to use it in bad times (Azeem et al., 2015). The Basel addresses risks relevant to bank-specific portfolios and the macroeconomic environment. It mandates requirements for higher minimum capital and higher quality capital. Besides, it introduces leverage ratios with the intent of improving financial system resilience, by limiting a banking organization's leverage. Likewise, the implementation of Basel III also introduces liquidity risks which 30-day liquidity coverage ratio (LCR), one-year net stable funding ratio (NSFR), and liquidity monitoring tools (only the LCR has been introduced in the US). There are two (2) mandates, first, enhanced disclosure requirements and second is interaction between LCR and the provision of central bank facilities.

The new proposed revisions to the Standardized Approach will have consequences for the banking world. Basel I to III saw an increase in complexity and

risk-sensitivity. New proposed revisions, already named Basel IV, attempt to increase the risk-sensitivity of the Standardized Approach and improve the comparability of outputs from the advanced IRB Approach (Basel Committee on Banking Supervision (BCBS)). Besides, the risk-weights are no longer assigned on the basis of external ratings or simply a fixed percentage. Instead, risk-weights will be based on the predetermined risk drivers that are claimed to be capable of explaining credit risk.

However, there are consequences for banks if the proposed regulations become reality. It includes of a decreased reliance on internal models, standardized but more extensive data collection and risk reporting (Amorello, 2016). Furthermore, it might be cases of change in customer selection criteria, increasing the transparency in risk reporting, changing role of credit rating agencies.

### 2.3.2 Implications for Islamic Banks in Complying Basel Accords



Source: Hassan (2014)

**Figure 2.6:** Implications for Islamic Banks in Complying Basel Accords

As shown in figure 2.6 above, in complying the Basel accords III, Hassan (2014) stated that there are several implications for Islamic banks includes first is in terms of new capital requirements and ratios on Islamic banks, second, in terms of risk computation of Islamic banks, third, in terms of leverage ratios on Islamic banks and lastly, in terms of new liquidity ratios on Islamic banks.

First, in terms of new capital requirements and ratios on Islamic banks, the Basel committee has decided to increase all the capital ratios with a progressive period from the year 2013 to 2018 (Boumediene, 2011). As required in the guidelines from Bank Negara Malaysia (BNM) for *Musharakah* and *Mudharabah*, under section 7 stated that the requirement of capital adequacy based on these contracts shall be subject to the capital adequacy frameworks issued by BNM. In the case where Islamic banks undertake direct exposures in property development and investment activities under these contracts, the computation of capital adequacy requirement shall be guided by Bank Negara Malaysia's Guidelines on Property Development and Property Investment Activities.



Source: Basel Committee on Banking Supervision & Boumediene (2011)

**Figure 2.7:** Basel III New Ratios

For instance, the minimum level of common equity ratio will increase from 2% to 4.5% when the minimum level of capital adequacy ratio pass from 9% to 12% as shown in figure 2.7 above which build-up of common equity and conservation buffer over time.

**Table 2.2:** Categorization of Capital according to Basel II and III

Basel II		New Standard	
<b>Tier I</b>	Common stock and other forms of Tier I (Including perpetual)	<b>Tier I</b>	Common equity (common stock plus retained earnings and OCI)
	Disclosed reserved (Including minority interests)		Additional going concern capital
	15% innovative instruments (Annex 1 to Basel II)		n.a
	Deduct goodwill and equity from securitizations		Deduct goodwill and many other items 1:1 from common equity
	Deduct 50% of investments in other financial institutions		Transformed into 1:1 adjustment
<b>Tier II (Max 100% of tier I)</b>	Undisclosed reserves and asset revaluation.	<b>Tier II</b>	Only one form of tier II capital remains
	General loan loss reserves		Unrealized gains will be reviewed by Basel Committee
	Hybrid capital instruments		n.a
	Subordinated debt (max 50% of tier I)		n.a
<b>Tier III</b>	For market risk coverage (limitations apply)	<b>Tier III</b>	n.a

(Source: Basel Committee on Banking Supervision (BCBS))

Furthermore, there are three (3) classification of capital structure defined in Basel II: Tier 1, Tier 2 and Tier 3. As shown in the table 2.2 above, Basel III has severely impacted the new definition of the capital under Basel III.

The Basel committee has decided to increase the importance of tier I capital under the Basel III as in fact the common equity and hybrid capital. The tier 2 capital is reduced subsequently and the tier III is abrogated. To extent this further, capital

structure is not the same for Islamic banks as which Islamic banks operate in line with the *Shariah* principles. The operation of Islamic banks cannot pay or receive interests (*Riba*) on their financial instruments. The significance value is that the banks mobilize and utilize capitals using *Shariah*-compliant contracts that are not used by their conventional counterparts.

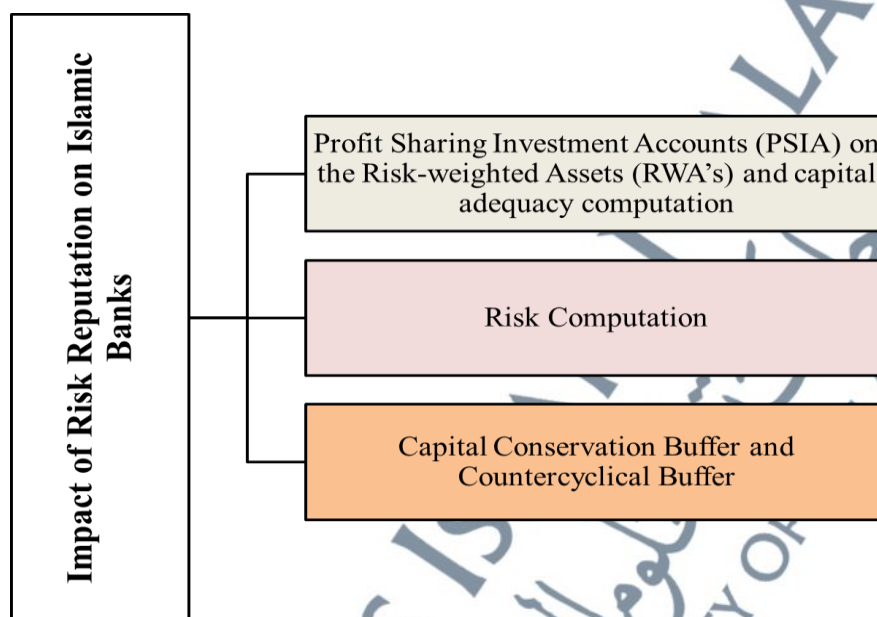
The use of tier II in the capital of Islamic banks is very uncommon as in general it is capital or hybrid capital connected to the payment of interest and thus tier II capital is limited to 50% of the total of tier I plus tier II capital (Ahmed, 2014). Therefore, it is not the case for the Islamic banks for the reason that their capital is basically compounded of common equity (and rarely of Tier II products) when the re-definition of the capital has a reasonably important impact on the conventional banks.

Hence, Basel III undoubtedly has a positive impact in terms of competitively for the Islamic banks, as the conventional banks will see their capital (all things being equal) declined by a larger share than the Islamic banks, hence the former will then experience higher costs of compliance than the latter.

In the lasts, the new capital requirements and ratios has given the influence towards EBF which enhance the application in the investment management and proper monitoring. As appointed out by Siddiqui (2006), he argues that these contracts will diminish triggering problems in adverse selection and moral hazard, which subsequently, downplays the credit risk of Islamic banks.

Essentially, Islamic banks need information symmetry and transparency in their transactions since Islam forbids excessive uncertainty (*Gharar*). Additionally, gambling (*Maysir*) is prohibited, which means that excessive risk-taking is not permitted. To end with, Cihak and Hesse (2010) argue that more difficult right of

entry to liquidity for Islamic banks entails that they should be more discriminate and as a result that they will not suffer a greater risk of moral hazard.



Source: Ahmed (2014)

**Figure 2.8:** Impact on Risk Reputation of Islamic banks

Second, in terms of impact on risk reputation of Islamic banks, there are three (3) impacts which include of profit sharing investment accounts (PSIA) on the risk-weighted assets (RWA's) and capital adequacy computation, risk computation and capital conservation buffer and countercyclical buffer in Islamic banks as shown in figure 2.8 above.

According to guidelines from Bank Negara Malaysia, profit-sharing investment accounts (PSIAs) denotes to deposit product structured based on *Mudharabah* (profit-sharing) contract where IAH and Islamic banks agree to share the profit generated from assets funded by PSIA based on an agreed profit-sharing ratio, while losses shall be borne by the IAH.

Islamic Financial Standard Board (IFSB) has issued some supervisory standard that constitute the equivalent of Basel II for Islamic finance in year 2005- issuing a guideline which help Islamic banks to calculate a ratio equivalent to the Basel II capital adequacy ratio by in taking into account the PSIA's specificities of Islamic banks (Ahmed, 2014).

Hence, the consequence of this amalgamation of the PSIA's concept is to leave a proportion  $\alpha$  (alpha) of RWA (Credit Risk + Market Risk) for unrestricted PSIA as part of the denominator, with an modification for RWA financed by Profit Equalizations Reserves (PER) and Investment Risk Reserves (IRR) within equity of investment account holders which absorb risk. As a result, the capital amount of PSIA is not guaranteed by the Islamic bank and any losses are for the owners of these PSIA's and hence do not require any regulatory capital requirement. This indicates that assets of PSIA's should be excluded from the calculation of the denominator of the capital ratio.

However, Archer and Rifaat (2009) argue that there are two (2) challenges of PSIA which it includes of regulatory problems in jurisdictions and problem in supervision. First, issue in jurisdiction occur as bank deposits are required by legal definition to be 'capital certain' but then the presence of such 'puttable instruments' in the capital structure leads to difficulties in evaluating their capital adequacy. Second, issue in supervision is because of the PSIA holder have no such right in governance and this is difficult for unrestricted PSIA holders who have no choice in determining the types and risk-return characteristics of the assets in which their capital are invested.

On top of that, the PSIAs on RWAs and capital adequacy computation have given the effects on equity-based financing contract for *Mudharabah*. One of the effects is in terms of weak market discipline across Islamic banks (Wasim & Atmeh, 2016). PSIA holder's behaviours in general show weak response to the different types of risks exposures through quantity and price mechanism. Thus, this matter gives a result of insufficiency in transparency of Islamic banks.

In terms of risk computation, the role of Islamic banks as they allow their customers and others investors to earn a potential return on their accounts and hence exposed to the same risks as conventional banks (Ahmed, 2014). The implementation of Basel III sets out a better risk coverage and develops new supervisory and risk management guidelines with several new tools for the risk computation and these would buoy up Islamic banks to strengthen themselves in their audit, risk, compliance and capital management functions.

One of the impacts toward Islamic banks is that they have high in credit risk in equity-based financing contracts compared with other types of contracts. It is because to the importance of equity-based financing (*Mudharabah* and *Musharakah*), valued at their accounting value and which are instruments held by the banks in their accounts for investment reasons and in general kept until their maturities. The implementation of Basel III introduced some measures in order to limit the credit risk due to counterparty credit exposures and improve the coverage of the risks related to capital market activities, especially counterparty credit risk on over the counter derivatives (Gollin & Delhaise, 2013).

The impact of the requirements in terms of RWA which includes of asset value correlation, counterparty credit risk in the trading book and additional requirements

for the securitization will increase intensely the amount of RWA. The increase of RWA due to Basel III which between 10% and 30% of the RWA under Basel II as this is due to the fact that conventional banks have normally a consequent trading book which is higher than in the major parts of the Islamic banks. Since Islamic banks cannot invest in all the financial instruments and thus the major part of the additional RWA is linked to such instruments that Islamic banks do not hold in their portfolios. Therefore, it is argue that Islamic banks will experience a far lesser RWA increase than the conventional banks and it is nevertheless difficult to quantify this impact and it depends clearly of the trading portfolio structure of each bank.

Furthermore, in terms of capital conservation buffer and countercyclical buffer in Islamic banks, these buffers should be applied as it quite different from the investment risk reserve and the profit equalization reserve (Ahmed, 2014). Nonetheless, the calculation of these buffers should take into account the specificities of the Islamic banks and particularly the presence of PSIA. Hence, as investment account holders (IAHs) take a part of the risk, it should be deducted from the total RWA the parts which depend from the PSIAs and compute, after deduction the required amount for the 2 buffers.

To extent these further, if some gains should be retained in order to accomplishes the required ratio for the new buffers, banks should not retains neither the earning of the IAHs or from the two specific Islamic reserves- profit equalization reserve and investment risk reserve (PER and IRR). This is because these two reserves are not compounded from income of the bank shareholders but from the income of the IAHs. As a result, if retained-earning should be done, bank's shareholders should transfer their own income in these reserves (Ahmed, 2014). Except this point, the

impact for banks itself are the same and the presence of PSIA is not something so appropriate which can increase much the competitiveness of Islamic banks with regard to the conventional ones.

Third, in terms of impact towards leverage ratios of Islamic banks, it is a very difficult requirement it will be much impacted by this guidelines which work and deal on the financial markets with a high leverage (Ahmed, 2014). For Islamic banks itself, they should not experience more constraints under the leverage ratio since there are commonly limited before by the risk management of their liquidity. Nonetheless, as the business model established by the Islamic banks is more a universal banking model, it can reasonably anticipate that the leverage ratio will not be a real constraining point for Islamic banks.

Undoubtedly, the calculation of leverage ratio for Islamic banks will increase its participatory as regard to the conventional banks. For instance, it was not abnormal in the past to realize some banks with a leverage ratio of 1.5 or 2%. With a limit of 3%, these banks should not have a total exposure above 33 times of their capital.

Fourth, in terms of new liquidity ratio on Islamic banks, in general, a comprehensive of liquidity management is one of the main vital difficulties as the debt could only be resold under very constricting condition and at its nominal value. The implementation of Basel III of liquidity requirements will have emotional impact towards lack of a developed Islamic money market and lack of liquid Islamic investment instruments with short term maturities.

Undoubtedly, LCR and NSFR are not calibrated for Islamic Finance and do not take into account the specificity of this industry. Under the LCR, it misses the

abundance of *Shariah* Compliant short-term instruments and then for the NSFR, there is no large amount of longer-term liabilities that can be withdrawn at short-term.

Despite of these matters, the reasons for Islamic banks not penalize more than today because of the existence of a major competitive distortion due to the lack of short-term liquidity instruments in Islamic finance and hence an initiative has implemented that will enhance the liquidity possibilities in terms of liquidity management (Hassan, 2014). The establishment of Islamic Financial Services Board (IFSB) aims to aware that the liquidity is a real problem and thus attempts to found some solutions in order to improve liquidity for international Islamic institutions with the establishment of International Islamic Liquidity Management (IILM) in year 2010 (Romzie Rosman & Abdul Rahim Abdul Rahman, 2015).

## **2.4 Underpinning Theories of Islamic Banking**

### **2.4.1 Resource Dependence Theory**

Resource dependence theory becomes one of the leading theoretical coherent that enlightens essential phenomena as one of the reason that organizations take on merger and acquisition activities as it helps them to reduce competition and enable them to exchange operations and expertise (Pfeffer & Salancik, 2003). Thus, firms are able to meet each other's objectives and goals in collective manner.

As such, mergers are among one of those strategies that corporations utilize to overcome environmental interdependence (Miner, 2005). To simplify, this theory explain that organizations require limited resources for continued existence and these resources are available in the environment. Hence, organizations have

interdependence on environment but in case an organization fails to manage these resources than it can cause uncertainty for that particular firm.

This theory focuses on the role of board directors in providing access to resources needed by the firms or organizations (Roundy & Bayer, 2019). The resources are derived from insiders, experts, support specialists and community influential which they provides specific resources based on their expertise in specific area. Likewise, the resources may be in the form of legal advice, skills and information. For instance, directors bring in valuable resources to the boards in which they contribute their knowledge, skills and expertise that they obtain from their educational qualification and work experience.

Basically, firms use this theory in strategic decision-making. The directors will ensure the essential resources are provided and secured to an organization by having a networking with the external environment (Schildt et al., 2010). The resources provision is important as it determines and encourages organizational functioning as well as firm's performance and survival. By means, this theory suggests that organizations require resources that they can obtain from the environment in which they operate to survive.

There are three (3) factors that can determine the dependence of a firm on scarce resources (Pfeffer & Salancik, 2003). These factors included of first is the value of the resources for the firm, second, insufficiency of that resource and third, the competition between firms to control that particular resource. Therefore, this theory explains that firms should create and maintain the long-term and efficient associations with the environment so that the effect of uncertainty on firms' performance can be minimized (Vestrum & Rasmussen (2013).

To simplify, this theory in general emphasizes that the resources should be managed effectively and efficiently since it becomes a benchmark in determining the success of an organization (Pfeffer & Salancik, 2003). On the other hand, the resources should not be in term of directors' expertise only, but the ability to have contact with outside network should be concerned as it gives chances to the company to access to new markets, sources of finance and reputation benefits.

However, problem arises when the firms are involving in this mergers and acquisitions. One of the problems is power imbalance. Basically, the more powerful firm views the dependent firm as ineffective (Pfeffer & Salancik, 2003). Hence, the powerful firm tends to exploit the resources for their own benefits and advantages. Consequently, the satisfaction level among the dependent firm will decrease and it leads to a greater hostility and dissatisfaction with the relationship.

In terms of risk-taking, the boards that have a wide set of skills and have greater experience are prudent in risk-taking due to their good understanding of the organization's risk appetite. Further, board members should be financial literate to make risky decisions (Pfeffer & Salancik, 2003).

For Islamic banking especially, *Shariah* Supervisory Boards (SSB) members consist of *Shariah* scholars who contribute their resources in SSB's deliberations and decision-making. Htay & Salman (2013) stated that SSBs represent shareholders and depositors of the IBs to certify and ensure financial contracts, transactions and banking activities are in accordance *Shariah*. Hence, SSB members who are *Shariah* experts must have educational qualification and experience in *Shariah*.

In addition, SSBs should also compose of members who have financial knowledge or banking experience that enable them to carefully assess financial

contracts applied to banking products and services of IBs (Ramly & Nordin, 2018). It is assumed that for Islamic banking, the higher percentage of *Shariah* advisors with *Shariah* and banking related experience in SSBs reduces risk-taking.

Likewise, resource dependency theory in Islamic context stated that the term resources relate to the board of directors particularly the board size and the board composition in regards of corporate governance (Ramly & Nordin, 2018). There is no universal agreement on the optimum size of a board of director but typically a board with a large number of members can pose challenges in terms of its effectiveness and level of meaningful individuals' participation.

With regard to the board composition, the theory suggests that an organization can minimize uncertainty and manage dependence by way of inviting a representative of the source of constraint onto its governing board, thus exchanging sovereignty for support (Ramly & Nordin, 2018). In other words, it refers to someone from outside the organization that holds some form of financial interest to be appointed as a member of the board such as the non-independent director.

This theory seems to support the view of co-operation through mutual interdependence (Ramly & Nordin, 2018). This principle is recognized in Islam as it is part of the ethical virtues. The concept of cooperation is encouraged in Islam, since human being is interdependence each other. Furthermore, Allah commands the Muslim to work together and help one another.

Nevertheless when it comes to merger and acquisition the dominant firm may sometimes take advantage on the dependent firm's weaknesses. The former one may exploit the resources of the dependent firm. Islam prohibits from consuming one's wealth or property unjustly.

Overall, this theory contradicts with *Shariah* rules because one party will take for granted on the other party resources for its own benefits. Even though the concept of this theory is based on mutual benefit that is parallel to Islam, in most occasions, there exists exploitation of resources. On the whole, this theory is not in favor in the light of *Shariah* (Ramly & Nordin, 2018).

To fill up the loopholes of this research, this urges this research to explore the issues of EBF implementation by exploring this theory from the Islamic perspective. This shows that this theory is not completely in line with *Shariah* since this theory self-interest motive and are lack of considering the ethical and social responsibility and fairness to all the involved parties. It is believed that this research opens the eyes of the regulators, industrial players and investors to recheck the suitability of these theories for the Islamic financial institutions.

#### **2.4.2 Efficiency Theory**

The term and concept of efficiency was first developed by Edgeworth (1881) and Pareto (1927) and recorded its empirical implementation in the book of Shephard (1953). It is known as general performance indicator for all types of business. To simplify, efficiency can be defined as the ability of an organization to achieve its output from the minimum input level. As such, it is the measure of effectiveness that produces the minimum waste of time, effort, and skill.

The term efficiency is different from the term effectiveness, both are used to describe the performance of an entity but according to Jouadi & Zorgui (2014), efficiency summarizes the idea to produce with the best manner, which means that efficiency is focused on the use of minimum inputs to produce the best output, in other

words, the optimized use of resources to generate the best products with the minimum costs.

Regarding the banking sector, Nasir et al. (2016) stated that efficiency supports the fruitfulness of implemented macroeconomic policies, which generate the durable development, economic growth, and welfare for society. To determine what constitutes efficiency of banks, one should first decide on the nature of banking approaches. There are two main approaches that are widely used in the banking theory literature, namely, production and intermediation approaches where (Sealey & Lindley, 1977).

The production approach assumes that financial institutions serve as producers of services for account holders; that is, they should perform transactions on deposit accounts and process documents such as loans.

The intermediation approach is of the opinion that banks basically act as financial intermediaries whose primary role is to obtain funds from savers in exchange for their liabilities, and the banks, in turn, will provide loans to others for profit-making

Berger & Humphrey (1997) argues that neither of these two approaches is perfect because they cannot fully capture the dual role of financial institutions as providers of transactions/document processing services and also being financial intermediaries. They point out that the production approach may be somewhat better for evaluating the efficiencies of bank branches, and the intermediation approach may be more appropriate for evaluating financial institutions as a whole.

Diallo (2018) stated that efficiency makes banks more resilient to shocks, thereby positively and significantly affecting growth. Bank efficiency relaxes credit

constraints and increases the growth rate for financially-dependent industries during the crisis. Waheed & Younus (2010) provides quantitative support to the view that the financial sector's development is crucial to economic growth and the efficiency of the financial sector is potentially important to the long-term growth performance of the countries.

Polouček (2004) stated that there is another way to classify Banking efficiency according to the following five types:

1- Pure technical efficiency: is the effectiveness with which a given set of inputs is used to produce an output. Banks' technical efficiency is defined as the difference between observed quantity of input and output variables with respect to optimal quantity of input and output variables. An efficient bank can achieve a maximum value of one in comparison to an inefficient bank, which can reduce to the level of zero.

2- Scale efficiency: is the ability of bank to reach the optimal operations. The bank has the scale efficiency when it operates in the range of constant returns to scale (CRS).

3- Allocative efficiency: measures a bank's success in choosing an optimal set of inputs with a given set of input prices.

4- Cost efficiency: is the ability of a bank to provide services without wasting resources as a result of technical or allocative inefficiency.

5- Scope efficiency: occurs when the bank operates in different diversified locations.

Concerning the determinants of banking efficiency, the process of producing outputs from inputs can also be influenced by both regulatory-specific variables (e.g.

bank type, ownership status and geographic region) and bank-specific variables (e.g. size, capital adequacy, asset quality, expenses and age) in explaining the variations in bank's efficiency estimates.

Al-Farisi & Hendrawan (2011) examines the impact of capital structure on performance of conventional and Islamic banks, by using profit efficiency approach. They measure profit efficiency score for each bank in Indonesia during the period from 2002 to 2008 by using distribution free approach (DFA). Result indicate that banks' capital ratio have a negative effect on their profit efficiency.

Sufian & Habibullah (2014) aims at exploring the impact of economic freedom on the efficiency of the Malaysian banking sector. Findings indicate that both greater freedom to start new businesses and restrictions on the activities of which banks could undertake tend to impede the efficiency of banks operating in the Malaysian banking sector.

There is a fundamental question that arises after reviewing the brief literature on general theory of Islamic banking. Do current practices of financing activities in Islamic banks perform efficiently? Although the phenomenon of Islamic banking and finance has developed significantly in recent years, only very few studies have tackled this central question.

Several authors assume that Islamic banks have lower efficiency than conventional banks for several reasons. First, the strict applying of *Shariah* rules means that many of the Islamic banking products are not suitable, thereby; it should tend to raise operational costs supported by Islamic banks. Second, several surveys raised the statement that Islamic banks tend to be small. It enabled many authors to pose the problem of technical efficiency of Islamic banks, which increase with the

institution's size (Abdul-Majid et al., 2005a; Chen et al., 2005; Drake et al., 2006; Isik and Hassan, 2002b). Third, Islamic banks are often domestically owned and the bulk of the evidences suggests that foreign-owned banks are more technically efficient than the domestically-owned institutions (Matthews and Ismail, 2006; Mokhtar et al., 2008; Sturm and Williams, 2004).

To fill up the loopholes of this research, this urges this research to explore the issues of EBF implementation as it seems that Islamic banking need to improve on the loopholes with regards to the contribution towards the social goals that may affect their efficiency to economic development. Islamic banking are assumed to further societal interests at large especially related with customer-oriented financing products such as EBF because the concept of profit-maximization alone may not be consistent with the overriding objective of optimally serving society and avoiding exploitation in their business operations. It is believed that this research opens the eyes of the regulators, industrial players and investors to recheck the suitability of these theories for the Islamic financial institutions. This present study, therefore, aims to fill this gap in the context of the Malaysian Islamic banking industry.

#### **2.4.3 Financial Intermediation Theory**

The neoclassical model of the perfect and complete market which was introduced by Marshall (1920) and Walras (1954) illustrate that financial intermediary can only function when market imperfections exist. If the markets are perfect, there is no room for financial intermediaries as savers and investors can find each other directly to make transaction since they have access to the perfect information needed without any impediments and at no costs.

The classical assumption was further expanded by Modigliani and Miller (1963) on the capital structure theory. They suggest that the value of a firm does not depend on how they are financed under the perfect and complete market setting. In other words, the theory states that the decision on capital structure is irrelevant in determining the value of a firm.

As such, imperfection that relates to asymmetric information also has gain great attention by numerous authors on its role for the existence of financial intermediaries. For example, Leland and Pyle (1977) suggest that an intermediary can signal its informed status on any project by investing its wealth in assets based on the privileged information they collect and manage. They formally demonstrate that a bank is able communicate information to investors about potential borrowers at a lower cost and if investors find the information by themselves it would be costly to observe. This suggests that the asymmetric information is significant in explaining the existence of financial intermediaries in the imperfect markets.

This contrasts with the Islamic scholar's view of financial intermediation as a value-creating economic agent. It also conflicts with the functions/objectives (*Maqasid al-Shariah*) of financial intermediaries. From this contrasting view, it can be concluded that current financial intermediation theory fails to provide a satisfactory understanding on the inclusive functions of financial intermediaries.

The critical analysis of this theory leads to several building blocks of theory on Islamic financial intermediation that aims at understanding and explaining the objective and the behavior of Islamic financial intermediaries through the unique structure of Islamic bank.

When information asymmetries are not the driving force behind intermediation activity and their elimination is not the commercial motive for Islamic financial intermediaries, the question arises which paradigm, as an alternative, could better express the essence of the intermediation process. As such, the assimilation of wealth and value creation through fully enriching the Islamic banking philosophical foundation might serve that purpose.

This research contributes to this line of inquiry in three perspectives: first, the doctrines of financial intermediation theory that reflect the objectives of their existence as part and parcel of the economic efficiency. Second, Islamic banks as financial intermediaries and third, the examination on the economic and social obligations of Islamic banking through multi-dimensional objectives studies for the quest of both aims in wealth creation and value creation.

The formation and development of Islamic banking objectives is highly associated by the role of religion as an essential guiding principle for their proper economic conducts (Dali et al., 2019). Along with the religious notion, Islamic bank is also integrated with the ethical identity and moral values which become the social dimension objectives intended for the benefit and interest (*Maslahah*) of society. In view of that, EBF is viewed as social welfare dimension financial contracts as it to be placed higher priority in the objectives of an Islamic bank in the theoretical practices side compared with SBF.

As such, the objectives of EBF are to embrace the social welfare dimension that are matches to the *Shariah* concern on promoting the concept of justice (*al-Adl*) and welfare (*al-Ihsan*) in society. These values are related to the

accountability of human being to Allah S.W.T and thus, have different implications from those of the norms of mainstream business ethics (Al-Zuhaily, 2007).

Thus, it is understood that the central intermediation functions of Islamic bank at large are far beyond merely on materialistic concern or profit motive. The main objective is essentially to contribute to the reaching of the major socioeconomic goal with the emphasis on the ethical, social, as well as moral elements in the wealth creation process. This will subsequently lead to the enhancement of equality and fairness for the welfare of the society at large as envisioned in the *Maqasid al-Shariah*.

With regards to the profit and growth concerns, Ayub (2007) argued that while growth has been the major objective of economic policy around the globe for about half a century ago, but the rising issue on the inequalities of asset distribution is also growing at even a faster rate. This problem arises because wealth and assets are only concentrated among the powerful and better-endowed groups, which subsequently result in increasingly desperate circumstances such as poverty and unemployment in the society since the system has failed to serve as the welfare function.

Based on the above scenario, it seems that Islamic banking need to improve on the loopholes with regards to the contribution towards the social goals that may affect social implications to economic development, especially in the fulfilment of EBF implementation as basic needs and achieving distributional equity as it more concern based on customer-friendly oriented.

Thus, the conception of social objectives in EBF with the economic objectives are needed to portray that Islamic banking is not pursuing its objective solely in terms of financial returns, but largely aiming at the welfare of the society to be better off.

Islamic banking should focus their objectives in becoming the catalyst for the development process that promotes economic and social well-being. These might include the contribution of Islamic banking towards the equitable distribution of income and wealth, the promotion of social justice and welfare and the promotion of equitable participation in the economy. From this, it has made the goal of any Islamic bank as multi-objective, which should incorporate both economic and social obligation into their business operations.

#### **2.4.4 Free Cash Flow Hypothesis**

One of the requirements for a firm to be *Shariah*-compliant is to have low cash, an important determinant of dividend policy. Companies having substantial free cash flows are subject to agency conflicts between manager and shareholders. According to the free cash flow hypothesis, managers are able to manipulate free cash flow under their control. Managers have the ability to use the remaining funds for their own benefits rather than to fulfill the interests of shareholders.

By paying more dividends, firms reduce free cash under the control of manager that can be used for their own interests. Most studies have been conducted to see the relationship between the agency costs of free cash flows and dividend. Alli et al. (1993), for example, document that firms with high amount of excess cash are more likely to pay dividends than firms with cash shortage. Byrd (2010) argues that firms that generate cash flow beyond that required to finance all positive net present value projects are particularly prone to agency problems.

The empirical evidence supports the Jensen argument that the debt and payout policy reduce the free cash flow problem. Khan et al. (2013), Cheng et al. (2014) and

Kadioglu & Yilmaz (2017) reach similar conclusions. According to these researchers, dividend payments divert the motivation of managers to use free cash flow for their own interests as little cash is available to managers for discretionary purposes.

To simplify, free cash flow can be introduced as a measure of performance measurement and reporting the economic value of the business unit. The basic assumption is that the value of the business unit is because of the company's ability to generate cash flows. Thus, the value of a company depends on the future cash flows, timing and risk of these flows.

This evaluation method considers all of the factors influencing the value of a company. Therefore, the remuneration committee and general meetings of companies use this scale to escape from the trap of accounting profit and other measures of the performance evaluation based on accounting numbers. EVA and free cash flow scales are the main scales of measuring the value that has not the failures of other accounting scales and try to coordinate the profits of shareholders' interests and the managers (Khan et al., 2013).

As such, consistent with avoidance of the free cash flow problem, it is revealed that the dividend payments of IB respond more strongly to free cash flow. Likewise, they are likely to pay out more of their free cash flow which can prevent managers from misusing the resources in ways that may not maximize shareholder wealth.

In addition to the above matters, diversification of products and production is one of the strategies in Islamic banking and many managers use them to improve the economic performance. Some companies as well as banking have not any variety and others have diverse products. Diversification is for increasing the company profitability through higher sales volume that can be achieved through innovative

products and new markets. Likewise, with the implementation of EBF as variety of financing products in the market, it should be noted that the decision-making on the diversification of their performance is in the priority. However, the variety of types should also be considered.

#### **2.4.5 Stakeholder Theory**

According to Stakeholder theory the sustainability of firms needs the support from the stakeholders (Freeman et al., 2018). The more powerful stakeholders, the more the company must adjust. Stakeholders can influence control of assets required by the corporation. For that reason, stakeholder's domination is determined by the level of control they have over the assets (Philips, 2003).

Therefore, when stakeholders have a control to significant resources of the organization, the company is such as to react in a manner that satisfies the stakeholders (Freeman et al., 2018). The government is one important stakeholder for the company; therefore the company will try to make disclosures based on the rules set by the government (Carroll & Buchholtz, 2014).

The Islamic perspectives on the stakeholder theory to the contrary, provide a more enduring and solid justification regarding who can qualify as a stakeholder and what are the rights and responsibilities that both firms and their various stakeholders may assume (Iqbal & Mirakhor, 2017). This framework is firmly established in Islamic principles of property rights and contracts. According to Iqbal & Mirakhor (2004), a stakeholder is defined as the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the firm. This implies that the firm is expected to preserve property rights of not only the shareholders but also those who

have participated in the process of acquiring or earning the firm's property, and those who could be threatened as a result of the firm's operation (Azid et al., 2007).

Indeed, the Islamic framework of contract places equal emphasis on obligations arising from both explicit and implicit contracts (Iqbal & Mirakhor, 2017). The former is clearly stipulated in the Islamic law of contracting that normally includes provisions that seek to protect the interest of parties involved in transactions. However, the law cannot take into account all the externalities incurred as a result of the firms' operation. In this respect, Islamic framework of contract and property rights obligates firms to honor the implicit contracts to the various stakeholders who might be affected by the firms' actions (Iqbal & Mirakhor, 2004).

These implicit contracts are more enduring since it is governed by the *Shariah*. In fact according to Al-Allaf (2012), the implicit contract is actually a divine contract that requires man to manifest the covenant (*al-Mithaq*) through his submission in absolute true willingness as prescribed by the Divine Law of *Shariah*. Indeed, the very foundation of the *Shariah* is covenant between God and man which imposes on man the duty of being faithful to his Lord. Failure to fulfil these obligations means he or she has breach the Divine contract, thus tantamount to betrayal with all the attending consequences in this world as well as in the hereafter (Bedoui, 2012).

A persons' relationship with his God should, by right, determine the mode of relationship with his fellow servants and not vice versa. The relationship and responsibility between man and his Master is in fact an actual and real contract stipulated by the so-called Divine contract (Chapra, 2008). This philosophical foundation of the Islamic society will avoid conflicting interests among members of the society, since everyone has a unity of purpose in his life that is to serve Allah. This

will inevitably lead to a society whereby every member will cooperate with each other rather than compete, as success in life is to obtain the ultimate happiness (*jalāh*).

For a devout *Muslim*, concern for others and the environment he lives in, is deeply inscribed in the pillars of Islam, binding on every Muslim (Mohammed et al., 2008). Therefore, concern for aggregate welfare of stakeholders is a moral and religious initiative based on the belief that a company should be “good” regardless of its financial consequences, be it positive or negative. This is not to suggest that Islam is against profit-making. Rather, it is seen as a necessary condition, though not the sole purpose, of their existence.

Hence, in regards of Islamic banking industries, it is an obligation for them to preserve sanctity of implicit contracts by recognizing and protecting the property rights of all relevant stakeholders such as customers, consumers, suppliers, employees and local communities. These property rights by and large are granted and preserved by *Shariah* to promote social order and economic development.

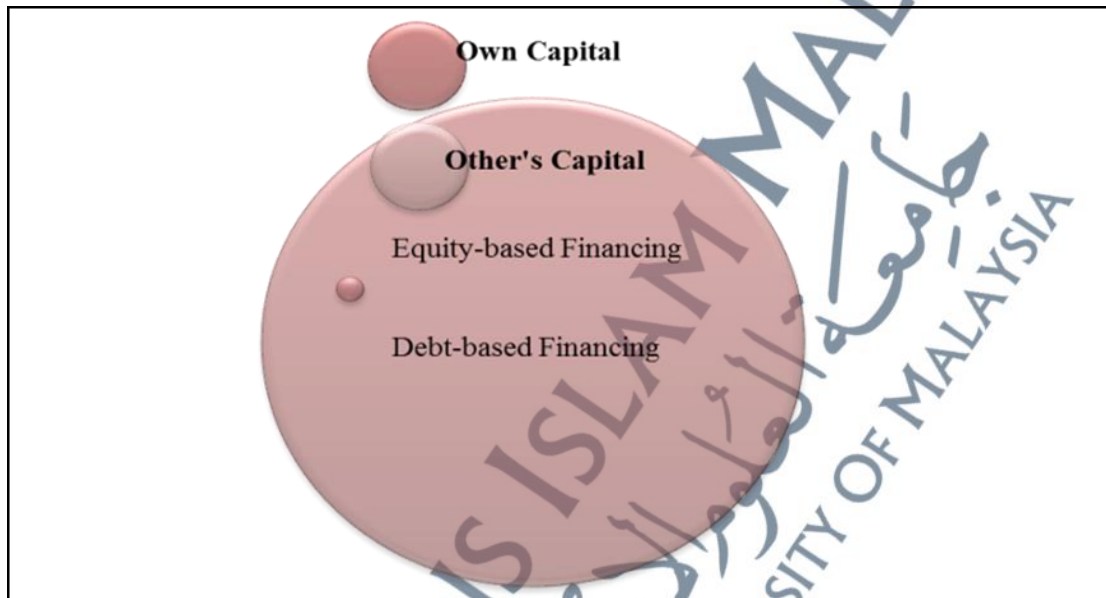
## **2.5 Islamic Financing Facilities in Islamic Banking System**

This subsection explains further the needs for financing facilities which discusses on the fulfilment of financing needs. Besides, this subsection also discusses sale-based financing (SBF) and equity-based financing (EBF) contracts.

### **2.5.1 Human Needs for Financing Facilities**

The development in Islamic banking system has expanded the needs of the society as it emerged and endured to meet the human needs for financing facilities.

The needs for financing facilities as for the growth of economic unit such as household, a firm or a government for fund or capital to carry out economics activities such as production, distribution or consumption.



Source: Saat et al. (2011)

**Figure 2.9:** Fulfilment of the Needs in Financing Facilities

Figure 2.9 above shows the fulfilment of the needs in financing facilities. According to Saat et al. (2011), there are two (2) sources of financing facilities- internal and external financing facilities. Internal financing facilities are comes from own capital and external financing facilities are comes from other's capital which are equity-based financing and debt-based financing.

## 2.5.2 Sale-Based Financing Contracts

### 1. Commodity *Murabahah/ Tawarruq*

Commodity *Murabahah/ Tawarruq* can be defined as a particular of sale of commodity of cost-plus financing as it consists of two (2) sale and purchase contracts. The first involves the sale of an asset by a seller to a purchaser on a deferred basis. Subsequently, the purchaser of the first sale will sell the same asset to a third party on a cash and spot basis (Bank Negara Malaysia, 2015).

Each sale and purchase contract in the *tawarruq* is binding in nature and shall not be terminated unilaterally by any of the contracting parties. The common inherent nature of each sale and purchase contract in the *tawarruq* is the transfer of ownership of the asset from the seller to the purchaser for a consideration. The sale and purchase contract in the *tawarruq* may take in the form of a *Murabahah* or *Musawamah*.



Source: Ismail (2010)

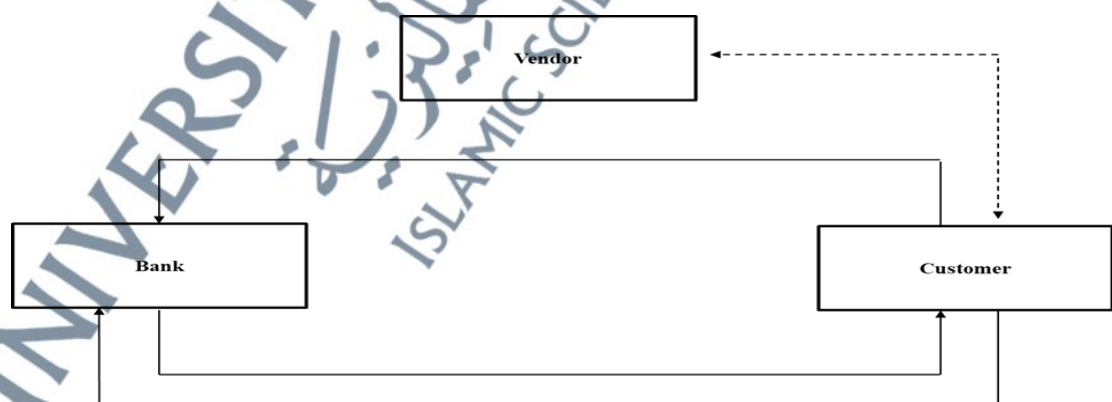
**Figure 2.10:** Modus Operandi of Commodity *Murabahah/ Tawarruq*

The modus operandi of this contract as illustrated in figure 2.8 above showed that bank purchases commodity seller in the commodity market on cash basis. Then, Ownership of the identified commodity will then be transferred to bank. Thereafter, the bank sells the commodity to the customer on deferred price, for example cost price plus profit margin.

## 2. *Bay' Bithaman Ajil (BBA)*

*Bay' Bithaman Ajil* is defined as a sale of deferred payments which works like as *Bay' Al- Murabahah* contract, but with payment generally made on a deferred basis (Kahf, 2015). This type of contract is a substitute of the finance lease and used by customers to purchase assets of substantial value in installments, from which they can generate future cash flows.

Furthermore, this type of contract enables the customer gets the asset and is required to make payments as per the agreed tenure in installments (Aziz, 2013). The customer purchasing the asset is required to pay the profit to the banks that arrange the assets.



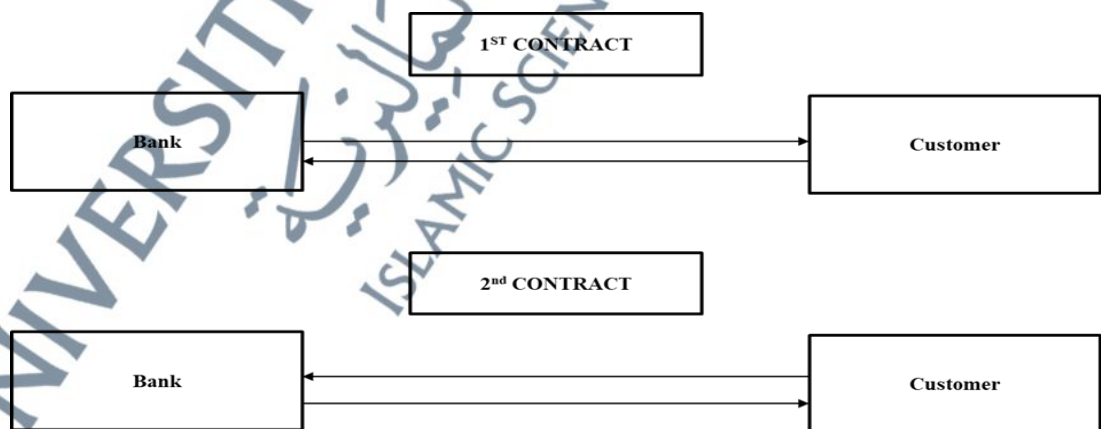
Source: Aziz (2013)

**Figure 2.11:** Modus Operandi of *Bay' Bithaman Ajil (BBA)*

The modus operandi of this contract as illustrated in figure 2.11 above showed that the customer first identifies the asset to be acquired and signs the sale and purchase agreement with the vendor. Then, the bank purchases the asset with bank's purchase price. Bank subsequently sells back to customer plus profit margin as per agreed among the contracting parties and then customer pays by installment based on the agreed period of time.

### 3. *Bay' Al-Inah*

*Bay' Al-Inah* is defined as a contract of advance payment and the transaction is considered to be sale of credit for the reason that the buyer of the commodity for a fixed time will collect its price from the seller in cash directly (Kahf, 2015). To simplify, it is a sale-based contract based on the transaction of *Nasi'ah* (delay) as the prospective debtor sells to the prospective creditor some commodities for cash payable on the spot, the debtor immediately buys the same commodity at a higher amount payable in the future, hence, the transaction leads to a loan.



Source: Aziz (2013)

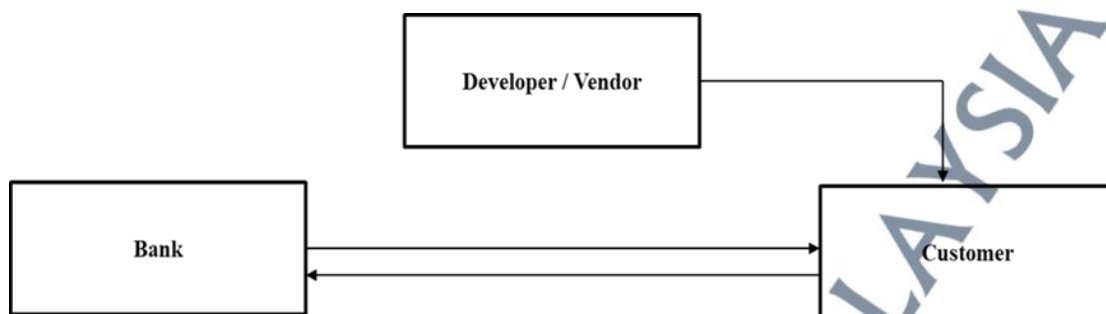
**Figure 2.12:** Modus Operandi of *Bay' Al-Inah*

The modus operandi of this contract as illustrated in figure 2.12 above showed that there are two (2) contracts involved. First is contract of sale and second is contract of purchase. Under the first contract, bank sells certain asset to customer on deferred term. Bank and customer enter into second contract which the situation that the bank subsequently purchases the asset back from the customer on cash basis.

#### **4. *Bay' Al-Istisna'***

*Bay' Al-Istisna'* is defined as a contract of exchange with deferred delivery, applied to specified made-to-order items (Kahf, 2015). To simplify, it is refers to a sale by order of items which is to be manufactured and delivered at a specified future date.

Under this type of contract, Kahr (2015) stated that the related parties will agree to construct and sell the project to be constructed at the bank's selling price on deferred payment terms and thereafter the bank will request another party (contractor) to construct the project which bank will purchase the project to be constructed at the bank's purchase price (cost price / facility amount). Upon completion, the contractor will hand-over the project to the bank or the bank will authorize the contractor to deliver the project directly to customer. The uniqueness of this contract enable the customer to plan their cash-flow since monthly payment is fixed throughout the financing period and can be canceled but only before the seller commences manufacture of the agreed item(s).



Source: Aziz (2013)

**Figure 2.13:** Modus Operandi of *Bay' Al-Istisna'*

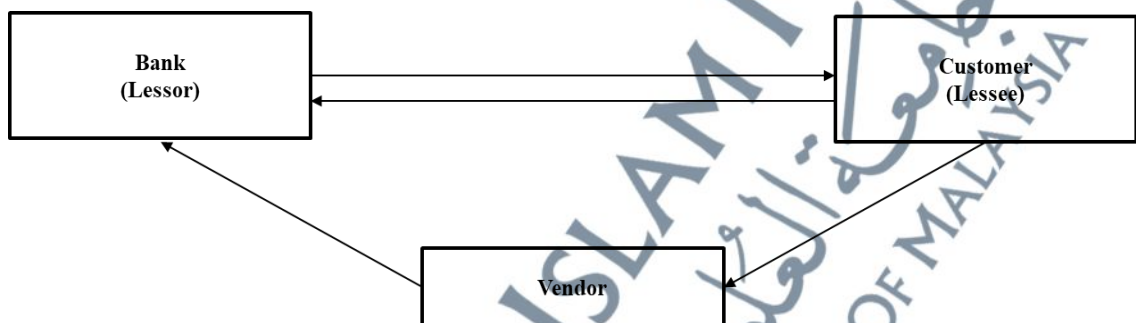
The modus operandi of this contract as illustrated in figure 2.13 above showed that the developer or vendor enters into a contract with customer, then the bank enter into this contract in the capacity of a seller to customer who demand a purchase for example a house. Next, bank draws a parallel sale by order contract in the capacity of a buyer with developer or vendor to construct a house as agreed upon in the first contract.

### 5. *Ijarah*

*Ijarah* is a term of Islamic *fiqh* which means to give something on rent (Kahf, 2015). The term of *Ijarah* is applied for two (2) different situations. The first situation is it means to employ the services of a person on earnings given to him as a consideration for his hired services. The second situation is relates to the usufructs of assets and properties and in this sense means to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.

Several of Islamic finance structures where *Ijarah* can be used. The purpose of Islamic banks applied this mode of financing as enabling customers to use durable goods and equipment such as ships, housing, heavy machines and plants in productive

enterprises who may be unable to buy them for their production purposes (Aziz, 2013). This type of contract has huge potential as a financing mode for retail, corporate and the public sectors and can also play a crucial role in promoting Islamic finance industry. It can be used as incentive to economic development as it is usually long term and offers potential for stimulating productive industries.



Source: Aziz (2013)

**Figure 2.14:** Modus Operandi of *Ijarah*

The modus operandi of this contract as illustrated in figure 2.14 above showed that the customer is appointed as lessee and bank as lessor. First, when entering this contract, the customer first identifies the asset or equipment to be leased from vendor. Then, bank purchases the asset or equipment at stipulated amount from vendor. Next, the bank leases the asset or equipment with monthly rental to lessee and lastly the customer pays the asset or equipment in monthly basis in stipulated period agreed.

### 2.5.3 Equity-based Financing Contracts

#### 1. *Musharakah*

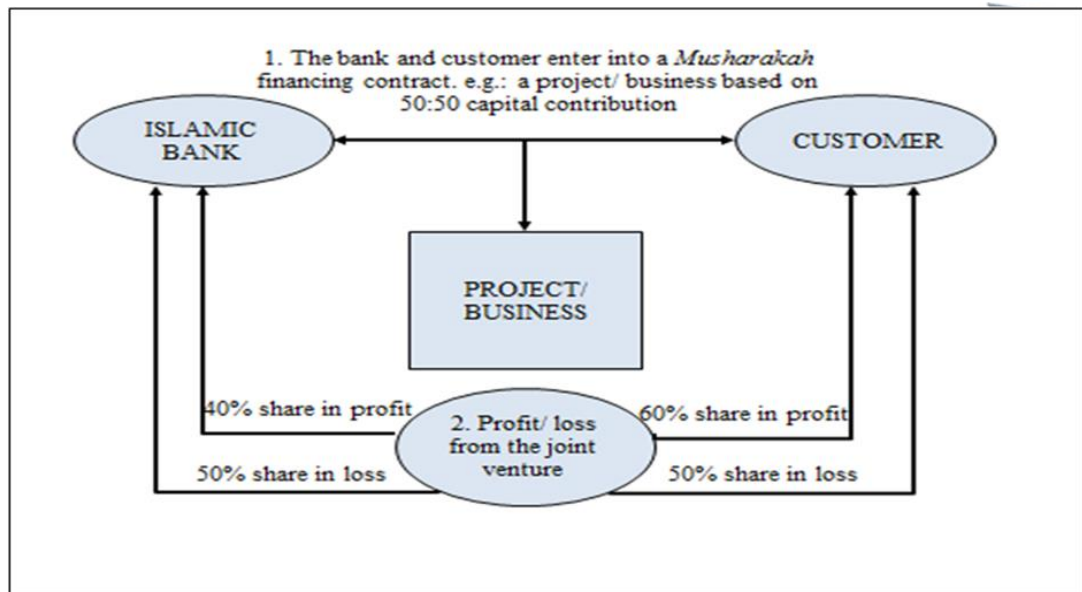
*Musharakah* is defined as a contract of partnership for association on the condition that the capital and its benefit are common between two or more parties (Aziz, 2013; Kahf, 2015). To simplify, it is a contract between two parties who launch a business of financial enterprise to make profit. Based on the above definitions, Mirakhor & Ibrahim (2015) stated that the ideas of partnership included are:-

**First:** The idea of capital contribution to a business either on a temporary or permanent basis. Therefore, the partnership can be used in the case of large users of funds to establish investment for short term or long term basis.

**Second:** The idea of profit-sharing basis over the business with the share of loss. Thus, a partnership needs to be defined as a contract between two or more persons in carrying out a particular business with a view of not only sharing the profit but also loss and liability.

**Third:** The idea of the partners share and control how the investment is managed.

**Fourth:** The idea that the liability in this partnership is unlimited. Therefore, each partner is fully liable for the actions and commitments of the other in financial matters.



Source: Aziz (2013)

**Figure 2.15:** Modus Operandi of *Musharakah*

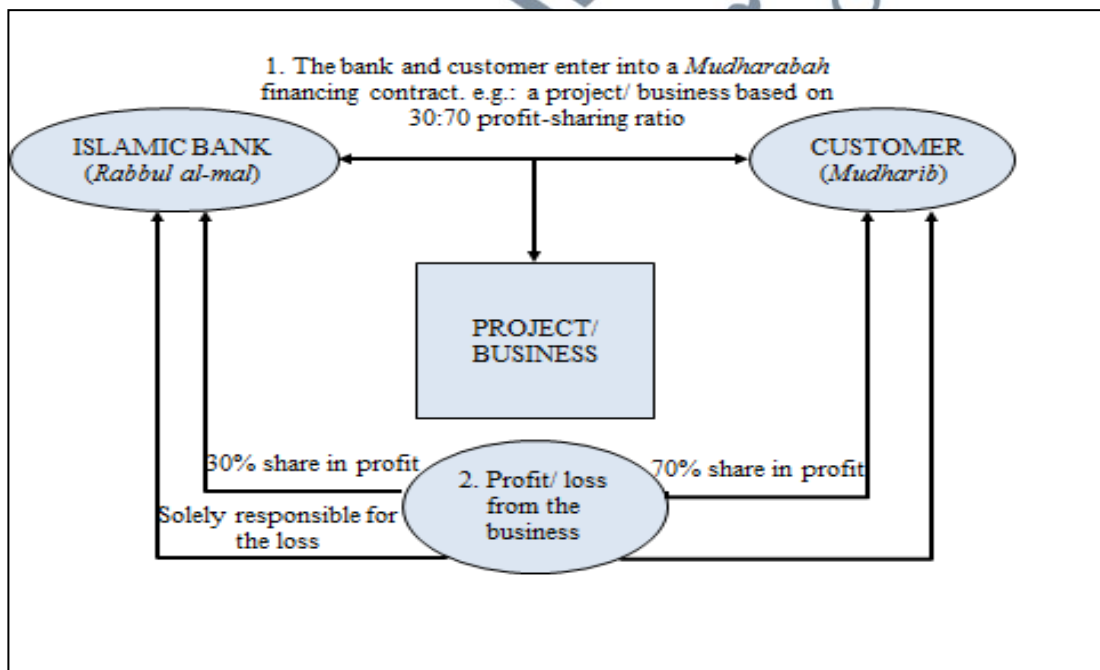
To simplify, figure 2.15 shows the modus operandi of *Musharakah* financing contract. The contract between Islamic bank and customer for example the project or business based on 50:50 capital contributions. Then the contractual parties would come to an agreement to the terms and begin a business in which both share a portion of the profits and losses and risk-sharing (Askari et al., 2012).

## 2. *Mudharabah*

*Mudharabah* is a special kind of partnership where one partner provides the capital (*rabb-ul-maal*) to the other (*mudarib*) for investment in a commercial enterprise (Aziz, 2013; Kahf, 2015). In terms of distribution of profit, it must be pre-determined by the two parties and the amount of profit ascribed to either of the parties must be independent of the capital amount, dependent solely on the actual profit

realized by the commercial enterprise. That is, the profit assigned to a party cannot be a percentage of capital amount contributed as that would be considered a fixed returns, or interest (Bidabad, 2014; Kureshi & Hayat, 2015). The profit assigned to either of the parties cannot be a lump-sum amount either as this would also constitute interest.

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio (Adham et al., 2012; Hanif, 2014). To extent this further, the *Mudharabah* becomes void (*Fasid*) if the profit is fixed in any way. In this case, the entire amount (Profit plus Capital) will be the *Rab-ul-Maal's*.



Source: Aziz (2013)

**Figure 2.16:** Modus Operandi of *Mudharabah*

To simplify, as stated in figure 2.16 is the modus operandi of *Mudharabah* financing contract. There are two parties included- Islamic banks as *Rabbul al-mal* and customer as *Mudharib*. These two parties enter into *Mudharabah* financing in conducting the project or business. The Islamic banks provide 100 percent of the capital for the project and customer who using his entrepreneurial skills, manages the project. Then the profits are distributed according to a predetermined ratio (for example: 30:70 ratios). Any losses accruing are borne by the provider of capital. The provider of capital has no control over the management of the project.

## 2.6 History and Development of Equity-based Financing Contracts

The establishment of equity-based financing (EBF) contracts since the Islamic banking system in practicing profit-and-loss-sharing practices (Kahf, 2015). These types of contracts are different in the philosophy of conventional banking as well as operations.

In terms of *Musharakah*, the development of this kind of contract has become one of the necessities contract since it allow the related parties to form a partnership contract as combine their capital, to share of profits and enjoy similar rights and liabilities (Saat et al., 2011). Evidence for the approval of partnership principles in Islam is seen in *Al-Quran* and *Hadith*, while *Hadith* narrations record that Rasulullah SAW realized people using *Musharakah* and did not prohibit it.

قَالَ لَقَدْ ظَلَمَكَ بِسُؤَالِ نِعْمَتِكَ إِلَىٰ نِعَاجِهِ ۖ وَإِنَّ كَثِيرًا مِّنَ الْخُلَطَاءِ لَيَبْغِي  
بَعْضُهُمْ عَلَىٰ بَعْضٍ إِلَّا الَّذِينَ آمَنُوا وَعَمِلُوا الصَّالِحَاتِ وَقَلِيلٌ مَّا هُمْ ۗ وَظَنَّ  
دَاوُدُ أَنَّمَا فَتَنَّاهُ فَاسْتَغْفَرَ رَبَّهُ وَخَرَّ رَاكِعًا وَأَنَابَ ۗ

“...and verily, many partners oppress one another, except those  
who believe and do righteous good deeds, and they are few..”

(Al-Quran. Surah Al-Sad. 38:24)

As narrated Abu Hurairah RA, Rasulullah SAW said:

“Whoever manumits his share of a jointly possessed slave, it is  
imperative for him to get that slave manumitted completely by  
paying the remaining price, and if he does not have sufficient  
money to manumit him, then the price of the slave should be  
estimated justly, and he is to be allowed to work and earn the  
amount that will manumit him (without overburdening him)”.

(Hadith, Sahih Al-Bukhari. Volume 3. Book 44. Number 672)

Rasulullah s.a.w adage this practice already prevailing over the business  
activities and he did also business on the basis of *Musharakah*. During the time of  
Prophet Rasulullah s.a.w., the *Muhajirin* and *Ansar* were declared to be brothers and  
they joined as partners in their trade and business. To extent these further, Islam also  
allow the practice of *Musharakah* financing since this practice are based on the actual

profit earned by the partner (joint-venture) and the financier can suffer loss if in the case that the joint-venture fails to produce fruits (Hanif, 2014; Kahf, 2015).

In contrast, the *Mudharabah* financing contract has developed during the prohibition of *Riba*' activities. Islam permits this practice because of the sanctity of contract where one party will supply the capital and the other the labour (Hanif, 2014). Likewise, this type of contract allows the capital provider to give the capital as a partner and eligibility in entitling to share profits and bear for losses. Evidence for the approval of *Mudharabah* is seen in *Al-Quran* and *Hadith*.

.. وَأَخْرُونَ يُقَاتِلُونَ فِي سَبِيلِ اللَّهِ ط

“...and others are travelling through the land, seeking of Allah's bounty...”

(Al-Quran. Surah Al-Muzzammil. 73:20)

In Hadith Ibn 'Awn said, Rasulullah SAW used to say:

“In my view land is like the wealth put into a *Mudharabah* contract. Whatever is valid with regard to the wealth put into a *Mudharabah* partnership, is valid with regard to land, and whatever is not valid with regard to the wealth put into a *Mudharabah* partnership, then it is not valid with regard to land.”

He said: “He did not see anything wrong with giving all of his land to the plowman on the basis that he would work with it himself, or with his children, and helpers, and oxen, and, that he would not

*spend anything on it; all expenses were to be paid by the owner of the land.”*

(Hadith. Sunan An-Nasaai'. Volume 4. Book 35. Number 3960)

## **2.7 Empirical Studies on Equity-based Financing Contracts**

The needs of equity-based financing (EBF) contracts for Islamic banking system has become one of the necessities in approaching reward-sharing elements which related to risk-sharing among the transaction parties. It needs also would increase the value and performance of Islamic banks and make them resilient to crisis. Conversely, the effectiveness of contributions in these types of contracts in attaining comprehension of Islamic banks and customers remains to be debatable.

To date, empirical research in equity-based financing contracts failed to convince that these types of contracts are approaching low level of contribution. As such, there are negative testimonies on the outcomes of low level of contributions. The case in Malaysia, these types of contracts recently contributes only 8 percent as reported by Bank Negara Malaysia (2018).

There are many reasons discussed in the literatures. It includes aspects of *Shariah*, legal, operational and risk. As such, these practices of equity-based financing contracts pursued the character but not the soul (essence) of Islam (Amir et al., 2015; Ebrahim & Sheikh, 2016; Djibrilla et al., 2017).

Regarding the *Shariah* matter, the transparency is one of the considerations that need to enhance the performance of EBF contracts. However, empirical research failed to convince there is issues arise of transparency in these contracts such as

management of risks-dimensions (Wulan & Hidayat, 2014; Bukair & Rahman, 2015; Srairi, 2019). Meanwhile, transparency problem is critical arise at present in the Islamic banking sector compared to conventional banks because one of the most vital facets in the global economy nowadays with a rapid development over the past five years in which it had perceived a growth rate of 15 to 20 per cent per annum (Lahrech et al., 2014; Shahri et al., 2015). Therefore, based on the findings from Khelif and Hussainey (2016) on how to enhance the transparency level, Islamic banks should disclose sufficient and reliable information which allows the assessment of its performances.

In terms of legal, the inadequacies of the disclosure of Bank Negara Malaysia (BNM) still remain concern. Ameer et al. (2012) found that only 2 out of 5 of full-fledged of Islamic banks followed BNM guidelines. Lack of expertise, outdated information system structure, shortage of support and lack of trained staff are the factors in inadequacies of disclosures of BNM (Yusoff & Oseni, 2019).

In terms of operational, there are many negative perceptions from the previous study regarding the equity-based financing contracts. As appointed by Hassan (2010), the understanding on the theories and practices in EBF contracts still remain with confusion and ambiguities. Further research by Kayed (2012) also has the same findings with Hassan (2010) that the difference between the theoretical perspective and the practical implementation of EBF contracts is in worrying level. In addition, he stated that negative attitude and lack of proper infrastructure of the majority of Islamic banks and also the unwillingness to put up entrepreneurship through the honest implementation of the contracts.

Also, Febiato (2012), Nabi (2013) and Othman et al., (2017) have claimed that operational matters in equity-based financing contracts are in terms of asymmetric information seems to be a triggering stipulation as it arising the transaction costs and moral hazards. As pointed out by Muda et al. (2013), level of optimal condition (banks as *Rabbul-mal* in asset side and banks as *Mudharib* in liability side) in getting the optimal point in these contracts affects the problems of three dimensions of triggering issues (asymmetric information, moral hazards and transaction costs).

Moreover, operational aspect in EBF contracts are concerned by Muhammad (2014), Hachicha and Amar (2015) and Hamza (2015) as they pointed out that lack of management's monitoring and controlling technique and the lack of risk-aversion approach of top management not only affects the low level application, but also with the communal factors such as moral hazard and high risk. Despite of these results, previous studies have the same discussion and argumentation that major causes of marginal use of these contracts of financing inherently more difficult to operate because of moral hazard, high risks, operational difficulties and adverse selection (Farooq & Ahmed, 2013; Marzuki & Worthington, 2015). However, recent study by Rahman and Nor (2020) stated that Islamic banks in Malaysia have great potential to offer EBF and mitigate risk by adopting the following five VC strategies: method of selection, channelling of funds, monitoring, non-capital assistance and period of investment. They proposed the channelling of corporate social responsibility funds for EBF as an initial step in applying VC strategy.

In terms of risk management practices aspect, a study by Ahmad and Rahman (2012) and Abdul-Rahman et al., (2019) found that liquidity and risk performance of Islamic banks contributes for performance of equity-based financing contracts. While

in terms of different types of banking system, the conventional banks are more profitable than the Islamic banks, while the latter is more liquid and less risky especially with respect to risk-weighted capital ratio than the traditional banks (Rahim et al., 2015).

Additionally, greater complexities and high risk level arising from the nature of specific risks (credit, operational, market and liquidity) also one of the reasons in approaching less participation in these types of contracts (Febianto, 2012; Othman et al. 2015).

## **2.8 Contribution of Knowledge regarding Empirical Studies**

Although there were researches examining and observing issues on equity-based financing (EBF) contracts in Malaysia, the studies were not comprehensive. Among the aspects investigated include *Shariah*, legal, operational and risk management practices. But still, none of the empirical studies were comprehensive enough to cover the identification the issues on EBF contracts in Malaysia based on in-depth interviews from experts.

Also, the theories of supply-side discussed earlier are important as has been accepted as dominant epistemologies which can be applied to integrate those theories with the elements found in EBF and there are propositions arise from the selected theories such as in offering risk-sharing, there are elements of co-operation among parties in return adapt the mutual benefit of profit-and-loss. Also, risk vulnerability discussed in efficiency theories are one of important preposition in handling the low level contribution of EBF. The financial intermediation theory in perspective of EBF

that IB act as partner in the contracts with offering PLS and lean transaction in real economic activity since it allow for share risk in return allocation for resources based on fixed-rate return. In minimizing cash flow problems, EBF is the best contracts as it allows PLS and high return as in return enhances the liquidity management. In addition, stakeholder theory stated that the implementation of EBF as new items to fill the important gaps in the field of corporate social responsibility such as the concern of justice contracts in 4 contribution-economic, legal, ethical and philanthropic.

Therefore, in such situations, it is good to go through thoroughly conducts interviews as to explore the reasons on the low level involvement of equity-based financing in Malaysia. Based on this technique in research in phase I, it is good to see how far the potentiality in implementing the EBF contracts in Malaysia by exploring the issues.

To fulfill the objectives, the study attempts to outline a profile of indicators of EBF contracts in Malaysia in order to increase the participation of involvements and strengthen the performance of Islamic banking system. Besides, it is good to get the real situations with different dimensions from the views of experts; therefore the suggestions from them are good for implication towards theory development, Islamic banks, and the customers and also for policy makers.

## 2.9 Chapter Summary

This chapter discussed on the philosophical underpinnings of Islamic banking, starting with an overview of chapter in section one. Section two discussed the evolution and performance of Islamic banking. Section three discussed the guidelines of BNM. Section four and five entailed the general theory of Islamic banking and the Islamic financing facilities in Islamic banking system which comprises of discussions on human needs for financing facilities, sale-based financing (SBF) and equity-based financing (EBF) contracts respectively. Section six discussed the history and development of EBF contracts. Next is the discussion empirical studies are under section seven. Section eight presented the contribution of knowledge regarding empirical studies and lastly, section nine concludes this chapter.

