

## CHAPTER 2

### SHARI'AH SCREENING IN MALAYSIA AND ISLAMIC FINANCIAL INSTRUMENTS

This chapter is divided into two main parts. Part one aims to overview the background of *shari'ah* stock screening in Malaysia. The section one explores Islamic equity market in Malaysia. International standard *shari'ah* stock screening is discussed in section 2, while section 3 reviews the development of *shari'ah* stock screening in Malaysia. Section 4 covers *shariah* rulings for mixed companies, while section 5 covers the foundation of the benchmark of one-third. Shariah Screening Methodology of Securities Commission Malaysia: Old and New Guidelines is discussed in section 6. The foundation of Islamic finance and the Islamic financing instruments, which contains profit and loss sharing financing instruments, sale-based financing instruments and *ijarah* financing instruments were discussed in part two of this chapter.

#### 2.1 Overview Islamic Equities Market in Malaysia

Generally, Malaysian Islamic Finance Industry contains three major parts namely Islamic financial institutions, Islamic capital market and Takaful. This study mainly focuses on Islamic capital market. As 31 January 2021, the size of Malaysian Islamic capital market stood at RM2.2 trillion, which is 66% of total capital market. While Islamic financial institutions and *Takaful* are RM835.2 billion and RM36.5 billion respectively (Zabidi, 2021).

*Shariah* Equities Market covers three markets of Bursa Malaysia namely Main Market, ACE Market and LEAP Market. *Shariah*-compliant Companies will

be equally listed on all three types of market due to company specific characteristics. Islamic equities contain *shariah*-compliant securities, Islamic ETFs and Islamic REITs (Zabidi, 2021). The *shariah*-compliant securities represent the major part of Islamic equities, which are the sample of the current study. Islamic ETFs are equity fund, which deal only with *shariah* compliant index and *shariah*-compliant securities (Zabidi, 2021).

### **2.1.1 *Shariah*-compliant Exchange Traded Funds (*i*-ETFs)**

In conventional terms, ETFs is an open-ended investment fund listed and traded on a stock exchange. Its liquidity reflects the liquidity of its underlying basket of shares. It contains few types of ETFs i.e., equity ETFs, leveraged & inverse ETFs, fixed income ETFs and commodity ETFs (Bursa Malaysia, 2021).

Unlike conventional ETF, *i*-ETF tracks only benchmark index where its constituents are *shariah*-compliant companies. The fund management of *i*-ETF has to strictly observe the *shariah* principles and Islamic investment guidelines. Bursa Malaysia lists number of *shariah*-compliant equity ETFs, which include MyETF Dow Jones U.S. Titans 50, MyETF Dow Jones Islamic Market Malaysia Titans 25, MyETF MSCI Malaysia Islamic Dividend, MyETF MSCI South East Asia Islamic Dividend, the VP-DJ *Shariah* China A-Shares 100 ETF and Tradeplus *Shariah* Gold Tracker (Bursa Malaysia, 2021).

### **2.1.2 *Shariah*-compliant Real Estate Investment Trusts (*i*-REITs)**

Real estate investment trust (REIT) is a collective investment scheme in real estate that combines the best features of real estate and trust fund. *i*-REIT is the

*Shariah* version of the conventional REIT. It was first issued in November 2005 by Securities Commission Malaysia (Bursa Malaysia, 2021). It is based on Islamic Real Estate Investment Trusts' guidelines, which makes Malaysia the first jurisdiction to introduce such guidelines in the industry. These are main guidelines for i-REIT that the income must be generated from permissible activities, however, in the case of mixed activities, the income from non-permissible activities should be less than 20% as a benchmark by the *Shariah* Advisory Council (SAC) of SCM (Bursa Malaysia, 2021). Currently, there are four i-REITs, which are listed on Bursa Malaysia namely Al-‘Aqar Healthcare REIT, Axis REIT, KLCC REIT and Al-Salam REIT.

This in part contributes to development of *shariah*-compliant companies and being popular and dominant Islamic product in Islamic capital market, which is one the three components of Malaysian Islamic Finance Industry.

### **2.1.2 International standard for *Shari'ah* Stock Screening**

The idea of establishing a *shariah* screening criteria dates back to 1987 by prominent of Muslim scholars including Muhammad Taqi Usmani, Saleh Tug and Sheikh Mohammad Al Tayyeb Al Najar (Adam & Bakar, 2014). This is in order to provide alternatives, which allow Muslim investors to own shares from one of the listed securities on the capital markets (Adam & Bakar, 2014). With this in mind, number of initiatives toward the type of *shariah* screening criteria at a country level and globally have come out. Currently, there are number of *shariah* screening indicts, which offer *shariah*-compliant securities. On the other hand, *shariah* screening methodology mainly focuses on qualitative and quantitative approach.

There is general agreement within the *shariah* screening indicts toward the qualitative approach, however, there are few differences in terms of ratios in some quantitative ratios/financial benchmark ratios. The following table 2.1 summarizes the key global *shariah* screening indicts in terms of quantitative ratios i.e., business activities and financial ratios to have a big picture about the existing *shariah* screening indicts and the applied methodologies.

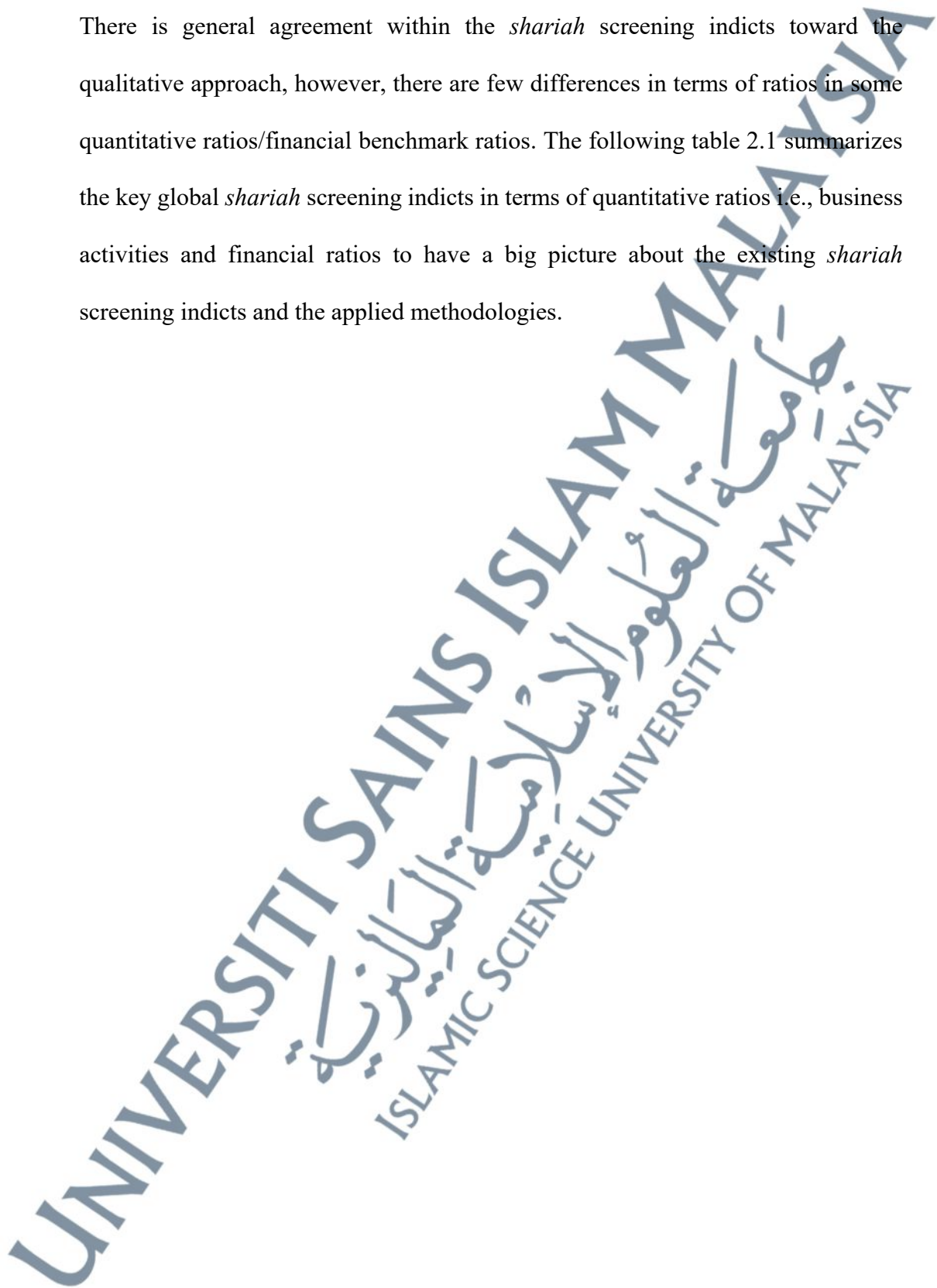


Table 2.1 compares major global *shariah* screening indicts

<b>Business activities</b>	<b>AAOIFI</b>	<b>DJIMI</b>	<b>FTSE</b>	<b>BM</b>
Income from Shariah non-compliant activities over total revenue/income	<5%	<5%	<5%	<5% & <20%
<b>Financial ratios</b>	<b>AAOIFI</b>	<b>DJIMI</b>	<b>FTSE</b>	<b>BM</b>
Debt over total assets	-	-	<33.333%	≤33%
Cash and interest-bearing items over total assets	-	-	<33.333%	≤33%
Accounts receivable and cash over total assets	-	-	<50%	-
Total debt divided by trailing 24-month average market capitalization	-	<33%	-	-
The sum of a company's cash and interest-bearing securities divided by trailing 24-month average market capitalization	-	<33%	-	-
Accounts receivables divided by trailing 24-month average market capitalization	-	≤33%	-	-
Interest bearing debt to the market capitalization	<30%	-	-	-
Interest taking deposits to market capitalization of total equity	<30%	-	-	-
Total market value of illiquid assets to market value of the total assets	≥30%	-	-	-
Sources	(AAOIFI,2015)	(DJIMI, 2021)	(FTSE, 2021)	(SCM, 2017)

### 2.1.3 The development of *Shari'ah* Stock Screening in Malaysia

Generally, the equity market is a vital component of the capital market in any economy. It provides an efficient avenue for firms to access capital and for individuals to invest by taking up shares in companies. The Islamic equity market (IEM) becomes a significant and fundamental aspect of the Islamic financial system (IFS) (Hashim et al., 2017). The challenging task is how to create and grow a substantive and inclusive Islamic equity market. This requires putting in place adequate support infrastructures such as regulatory framework and *shari'ah* authorities to list *shari'ah*-compliant companies separately from non-*shari'ah* companies in every interval period. The formation of the Securities Commission of Malaysia in 1993 was a major milestone and significant step towards establishing an Islamic capital market in Malaysia and it managed to produce its first list of *shari'ah*-compliant securities in 1997 according to the *shari'ah* screening methodology.

It was intended to build a relevant framework and *shari'ah* guidelines, which would facilitate the introduction of *shari'ah*-compliant products and services (IFWM, 2017). The introduction of SCM has boosted investors' confidence and helped the Malaysian Islamic capital market to grow at a significant rate of 11.7% annually during the period from 2005 to 2015 (IFWM, 2017).

The *Shari'ah* Advisory Council (SAC) of the Securities Commission Malaysia is the entity tasked with the production of an updated list of *shari'ah*-compliant securities through issuing a semi-annual report in May and November of each year. It issues the updated report based on audited annual reports and enquiries obtained through the Securities Commission (Securities Commission Malaysia, 2017).

The SAC applies a two-tier quantitative method, consisting of the business activity benchmarks and the financial ratio benchmarks to clarify the *shari'ah* status of the listed securities on Bursa Malaysia. Therefore, securities are determined as “*shari'ah*-compliant if their business activities and financial ratios stay within these benchmarks”. Otherwise, they will be labelled as non-*shari'ah* companies (Securities Commission Malaysia, 2017).

The Securities Commission Malaysia (2017) has reported that *shari'ah*-compliant companies represent 76% of listed securities on the Main Market of Bursa Malaysia. Besides, Malaysia also has introduced an Islamic regulatory framework that governs the dual banking system, whereby both Islamic and conventional systems operate side-by-side and co-exist within a signal regulatory framework (D'Cruz & Aziz, 2017). The Malaysian Islamic capital market has expanded and it currently is the umbrella body under which are 20 full-fledged Islamic fund managements such as some large international companies alongside other fund management companies involved in operating Islamic windows. Malaysia, thus, has RM149.60 billion (approximately USD 35.5 billion) worth of Islamic assets, making it one of the largest Islamic finance countries in the world (IFWM, 2017).

With the establishment of the Securities Commission Malaysia and other Islamic entities alongside the Islamisation policies of Bank Negara Malaysia, the market capitalisation of *shari'ah*-compliant equities represents 64.10% of total market capitalisation in Malaysia (IFWM, 2017). This is one of the primary reasons that motivated the current study to select Malaysian *shari'ah*-compliant companies as its sample.

#### 2.1.4 *Shariah* rulings for mixed companies

The SAC, at its 2nd meeting on 21 August 1996, discussed the status of companies running a mix of permissible and prohibited activities. The SAC resolved that such companies, with a certain degree of prohibited elements which do not exceed the benchmark set by the SAC, can be included in the list of *shariah*-compliant securities by the *Shariah* Advisory Council of the Securities Commission.

A mixed company is one where its core activities are permitted by *shariah*, although there are some other activities that may contain a small extent of prohibited elements. In order a mixed company to be listed in the list of *shariah*-compliant securities, these considerations to be met (Securities Commission Malaysia, 2006).

First, the core activities of the company must be activities which are not against the *shariah* principles. Furthermore, the haram element must be very small compared to the main activities. Second, public perception of the image of the company must be good.

Third, the core activities of the company have importance and *maslahah* (benefit in general) to the *Muslim ummah* and the country, and the haram element is very small and involves matters such as *'ulum balwa* (common plight), *'urf* (custom) and the rights of the non-Muslim community which are accepted by Islam.

There are two opposing arguments from Islamic jurists toward mixed companies. The first group is the group that prohibits the mixed companies, where the second group is on its permissibility. Imam Hanifa is considered as one of early generation that believe it is not permissible for Muslims to collaborate with non-Muslims through *mufawadhah* due to nature of business activities. On the second view, some Islamic jurists believe that it is permissible for Muslims to partner non-Muslims

in business, although it is not encouraged. Therefore, Muslims were allowed to invest in the shares of companies with a mix of permissible and prohibited activities is justified. The majority of the Islamic jurists allowed such transactions involving permissible and prohibited funding, provided the ratio of permissible funds is more (Securities Commission Malaysia, 2006).

Izz al-Din bin Abd Al-Salam said:

*“If the permissible money is more, that is, one dirham of prohibited money is mixed with one thousand of permissible money, then the transaction is allowed.”*

Al-Kasani also said:

*“Everything will be tainted by what is prohibited, but if the larger part is halal, then trade is allowed”*

Ibnu Taimiyyah said:

*“Should the permissible be more, then a business transaction will not be judged as prohibited... and should one’s wealth be found to have a mixture of the permissible and prohibited, then the permissible element will not be prohibited; on the contrary, the owner is allowed to take according to the permitted ratio.”*

### **2.1.5 The foundation of the benchmark of one-third**

The Prophet S.A.W.’s condition of 1/3 (33.33%) is a very generous limit which can also be considered for use as the benchmark for mixed companies. This statement can be supported by the legacy of Sa`ad Ibn Abi Waqas who wanted to leave his assets as alms as in the following hadith:

“One day, the Prophet S.A.W. visited Sa`ad bin Abi Waqas who was ill. Sa`ad expressed to the Prophet S.A.W. his feelings that his illness was entering the last phase

and that death was near. He asked for the Prophet S.A.W.'s opinion on giving his assets away as alms for he had only one daughter to inherit his wealth. Therefore, he wished to give as alms  $\frac{2}{3}$  of his property. However, the Prophet S.A.W. stated his objections. Then Sa`ad asked whether he could give away  $\frac{1}{2}$  of his property. The Prophet S.A.W. still said no. The Prophet S.A.W. then said:  $\frac{1}{3}$  (of Sa`ad's property to give away as alms) is enough, that too is still too much. Verily, to leave your heir wealthy is far better than to leave your heir impoverished and dependent on other people's charity".

Based on the Prophet S.A.W.'s words,  $\frac{1}{3}$  or 33.33% "is enough" and can be used as a guideline for the basis of formulating a benchmark. The question is whether this benchmark is suitable to be used for mixed companies, because it relates to the bequest of property and giving of alms. Even so, it cannot be denied that it can be used as a benchmark to set the upper limit of a mixture because an amount exceeding the percentage set will be considered excessive (Securities Commission Malaysia, 2006). The one third benchmark is the abase that allows the Islamic capital market to grow at significant rate, because it provides upper limit for mixed company, which use both Islamic debt and interest-bearing debt, to finance 33% of its assets from interest-bearing debt without losing its status and a *shari'ah*-compliant company.

#### **2.1.6 *Shariah* Screening Methodology of Securities Commission Malaysia: Old and New Guidelines**

In classifying these securities, the SAC received input and support from the SC. The SC gathered information on the companies from various sources, such as company annual financial reports, company responses to survey forms and through inquiries made to the respective company's management. The SC, through the SAC, continues

to monitor the activities of all companies listed on Bursa Malaysia on periodic basis based on availability of information to determine their status from the *shariah* perspective (Securities Commission Malaysia, 2012).

To determine the tolerable level of mixed contributions from permissible and non-permissible activities towards turnover and profit before tax of a company, the SAC has established several benchmarks based on *ijtihad*. If the contributions from non-permissible activities exceed the benchmark, the securities of the company will be classified as *shariah* non-compliant (Securities Commission Malaysia, 2012). The following two tables summarize *shariah*-compliant securities screening methodology before and after the adoption of new financial ratio benchmarks in 2013. The table 2.2 summarizes *shariah*-compliant securities screening methodology before the changes occurred.

**Table 2.2:** Previous *Shariah*-Compliant Securities Screening Methodology

<b>Quantitative assessments: Business activity benchmarks and financial ratio benchmarks</b>		
Business activity benchmarks		
Activities	Benchmark ratio	Remarks
<ul style="list-style-type: none"> <li>➤ Conventional banking;</li> <li>➤ Conventional insurance;</li> <li>➤ Gambling;</li> <li>➤ Liquor and liquor-related activities;</li> <li>➤ Pork and pork-related activities;</li> </ul>	≤5%	Non- <i>shari'ah</i> -compliant businesses revenue portion must be less than five per cent.
<ul style="list-style-type: none"> <li>➤ Tobacco and tobacco-related activities;</li> <li>➤ Interest income;</li> </ul>	≤10%	Non- <i>shari'ah</i> -compliant businesses revenue portion must be less than ten per cent.
<ul style="list-style-type: none"> <li>➤ Rental payment from the premise that involved in gambling, sale of liquor</li> </ul>	≤20%	
<ul style="list-style-type: none"> <li>➤ Hotel and resort operations;</li> <li>➤ Share trading;</li> </ul>	≤25%	Non- <i>Shari'ah</i> -compliant businesses revenue portion must be less than 25%.

<ul style="list-style-type: none"> <li>➤ Stock broking business;</li> <li>➤ Rental received from non-<i>shari'ah</i> compliant activities; and</li> <li>➤ Other activities deemed non- <i>shari'ah</i>-compliant.</li> </ul>		
Qualitative assessments	Public perception or image of the company's activities from the perspective of Islamic teaching The core activities of the company are important and considered <i>maslahah</i> (benefit in general) to the Muslim ummah (nation) and the country.	

Source: Securities Commission Malaysia November 2012 report

The table 2.2 clearly indicates that old *shariah*-compliant securities screening methodology contains two major criteria for assessment namely business activity benchmarks and qualitative assessments, which are public perception and image of the company's activities from the perspective of Islamic teaching. While the table 2.3. provides summary of the updated *shariah*-compliant securities screening methodology, which is adopted in November 2013.

**Table 2.3:** New *Shariah*-Compliant Securities Screening Methodology

<b>Quantitative assessments: Business activity benchmarks and financial ratio benchmarks</b>		
<b>Business activity benchmarks</b>		
<b>Activities</b>	<b>Benchmark ratio</b>	<b>Remarks</b>
<ul style="list-style-type: none"> <li>➤ Conventional banking;</li> <li>➤ Conventional insurance;</li> <li>➤ Gambling;</li> <li>➤ Liquor and liquor-related activities;</li> <li>➤ Pork and pork-related activities;</li> <li>➤ Non-halal food and beverages;</li> <li>➤ Non-<i>shari'ah</i>-compliant entertainment;</li> <li>➤ Tobacco and tobacco-related activities;</li> <li>➤ Interest income;</li> </ul>	≤5%	Non- <i>shari'ah</i> -compliant businesses revenue portion must be less than five per cent.

➤ Other activities deemed non- <i>shari'ah</i> -compliant.		
<ul style="list-style-type: none"> <li>➤ Hotel and resort operations;</li> <li>➤ Share trading;</li> <li>➤ Stock broking business;</li> <li>➤ Rental received from non-<i>shari'ah</i> compliant activities; and</li> <li>➤ Other activities deemed non- <i>shari'ah</i>-compliant.</li> </ul>	≤20%	Non- <i>Shari'ah</i> -compliant businesses revenue portion must be less than 20%.
➤ Cash over total assets	≤33%	This includes only cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments is not included in the calculation
➤ Debt over total assets	≤33%	This includes interest-bearing debt whereas Islamic financing or <i>sukuk</i> is not included in the calculation
Qualitative assessments	Public perception or image of the company's activities from the perspective of Islamic teaching	

*Source:* Securities Commission Malaysia November 2017 report

There are differences in terms of ratios of business activities between the previous and the updated *shariah*-compliant securities screening methodology, but that is not of the focus of the current study. However, the main difference is that under the updated *shariah*-compliant securities screening methodology, there are three major criteria for screening i.e., business activity benchmarks, financial ratios benchmarks and public perception and image of the company's activities from the perspective of Islamic teaching. The financial ratios benchmarks were introduced in this second version of *shariah*-compliant securities screening methodology, which are cash ratio and debt ratio. It falls within the range of zero to 33% of firm's total assets, it was issued by The *Shari'ah* Advisory Council (SAC) of the Securities Commission Malaysia.

Malaysia has developed these financial infrastructures in order to facilitate the growth of Islamic financial institutions and being a hub for Islamic finance in the region. This is in part one of the main reasons that led this study selected the listed *shariah*-compliant securities on Bursa Malaysia as the sample of the current study.

In summary, Part one aims to overview the background of *shari'ah* stock screening in Malaysia, International standard *shari'ah* stock screening, the development of *shari'ah* stock screening in Malaysia. It also covers *shariah* rulings for mixed companies and the foundation of the benchmark of one-third. The part two discusses the Islamic capital structure and Islamic financing instruments.

## **2.2 The Foundation of Capital Structure in the Islamic Capital Market and Islamic Financing Instruments**

The part two of this chapter discusses the foundation of the Islamic capital structure, Islamic financing instruments, which contains three major instruments i.e., profit and loss sharing instruments, sale-based financing instruments and lease financing instruments.

### **2.2.1 The Foundation of Capital Structure in the Islamic Capital Market**

In Islamic banking and finance, there are two major principles - prohibition of interest/usury and risk-return sharing principle (Ahmed, 2010). Islam prohibits *riba* (interest), which is the predetermined rate or promising up-front fixed amount (Abdul Gafoor, 2006). Literally, *riba* is an Arabic word, which means “an increase” or “accretion”. It is an increase in wealth based on lending money (Hussain et al., 2015).

The objection of interest is not due to the profit paid, but it is in fact a predetermined

return, which is not based on actual profits earned and losses incurred (Mirakhor & Zaidi, 2007). To avoid this, Islam promotes equity-based financing mode in which both parties, namely shareholders and creditors act as partners through a profit and loss sharing mechanism, namely *mudarabah* (“joint venture”) and *musharakah* (“equity participation”), which are part of a number of alternative financing instruments. This is generally to prevent interest rate in financial transactions and to eliminate it particularly from the entire economic life ((Khan & Bhatti, 2008).

On the other hand, there are *shari’ah*-permitted debt-based financing instruments through sale or lease-based contacts such as *murabaha* and *ijarah* contacts. This is because, *shari’ah* law is willing to offer various financial instruments, which enhance the current practice of Islamic banking and *shari’ah*-compliant companies and improve the risk diversification tools for Islamic banks and Islamic corporations. Nevertheless, the majority of Islamic jurists have a negative view about the heavy dependence on Islamic debt financing instruments in the current Islamic banking and *shari’ah*-compliant companies’ practice due to their similarities with the conventional financing instruments, which are mainly debt-based (Ahmed, 2006).

Theoretically, equity financing is the most preferred financing instrument in a debt-free banking system. Therefore, it was perceived to be the primary financing instrument in the current Islamic banking and *shari’ah*-compliant firm’s financing practice ((Jusoh & Khalid, 2013). However, the current experience indicates that the Islamic debt financing instruments, i.e., *murabaha* financing and *salam* financing have dominated equity-based financing instruments ((Jusoh & Khalid, 2013). This is due to the list of factors that advocate the use of Islamic debt, including borrowers’ preference, lack of long-term investment instruments and facilitating environment/reserve ratio,

needed for trade financing instruments, and moral hazard (Habib, 2005; Jusoh & Khalid, 2013). Therefore, one of the potential challenges in the Islamic financial industry is the replacement of overwhelming usage of debt instruments with the preferred profit and loss sharing financing instruments.

Moreover, the current *shari'ah*-compliant rules allow *shari'ah* companies to have a certain percentage of interest-based debt as a source of financing. Therefore, the debt will be a significant component of *shari'ah*-compliant companies' capital structure. Besides that, it is highly crucial to emphasise that the *shari'ah*-compliant companies are operating in economic, monetary and regulatory environments that are more or less similar to the conventional environment, which recognises the MM Irrelevant Theory's assumptions (Obaidullah, 2007).

By definition, *shari'ah*-compliant companies are "those companies which meet the *shari'ah* requirements, which are based on a two-tier quantitative approach namely, business activity benchmarks and financial ratio benchmarks." Therefore, the *shari'ah* screening methodology categorises the listed securities into *shari'ah*-compliant companies and non-*shari'ah* compliant companies. As such, the newly-revised financial ratio benchmark of the Securities Commission Malaysia suggests that *shari'ah*-compliant companies will only have 33% of firm's total assets as a conventional debt financing. Consequently, any firm that fulfills these criteria will be considered as *shari'ah*-compliant firm, while others are not (Securities Commission Malaysia, 2017). Moreover, this threshold ratio contains only a pure conventional debt, meaning that it does not include Islamic debt, raised through *murabaha*, *ijarah* and *sukuk* financing for instance ((Zainudin et al., 2014). However, in Islamic finance, one of the key requirements to raise a debt is that debt should be backed by a tangible asset.

Because of this condition, *shari'ah*-compliant firm managers cannot issue any amount of Islamic debt, if they do not have enough assets to back up and thus, the issued Islamic debt will be dependent on the value of the tangible assets held by the firm. As a result, *shari'ah*-compliant companies with low tangible asset ratio will have a relatively lower debt financing ratio and vice versa (Ahmed, 2007).

In the following section, the study further explains Islamic financing instruments, namely, profit and loss sharing instruments, sale-based financing instruments and lease financing instruments.

## **2.2.2 Islamic Financing Instruments**

### **2.2.2.1 Profit and Loss Sharing Financing Instruments**

Theoretically, equity-based financing is the ideal financing instrument in Islamic finance (Azmat et al, 2015). It is a desirable financing instrument of the majority of jurists ((Khan, 1994). It is also a profit and loss sharing instrument, i.e., *musharakah* and *mudarabah* (Aggarwal & Yousef, 2000).

Equity financing is based on the concept of *sharikah*, which can be either *sharikatul-milk*/ownership partnership or *sharikatul-aqd*/ contractual partnership. In the *musharakah* arrangement, both parties contribute capital and management skill to the newly -owned *sharikah*. The main dispute between the two equity instruments is that in the *mudarabah* contract, in the case of losses, the fund provider bears all the financial losses, while the management skill provider bears the opportunity cost of time and efforts. On the other hand, in the *musharakah* arrangement, the losses will be shared based on capital contribution ratios (Aggarwal & Yousef, 2000). However, in *mudarabah*, one party only contributes funds, while the other party provides

management skill to the newly-established joint business, Whereby, in both models, the profit is always distributed based on pre-agreed ratio in both equity arrangements (Ayub, 2007).

Moreover, the central argument of a *sharikah* contract is that both parties have to share the risk and the return, as they are associated with the investment. Nevertheless, it is not necessary for the sharing ratios to match capital contribution ratios, since the sharing ratio can be determined either based on capital contribution ratio or based on pre-agreed ratio (Ayub, 2007).

In the next section, the study discusses some features and details of equity-based financing instruments.

#### **2.2.2.1.1 Musharakah Financing**

*Musharakah* is an Arabic word, which literally means “sharing” (Arshad & Ismail, 2010). In terms of legitimacy, *musharakah* is based on *Qur'an*, *Sunnah* and *Ijma'* and hence, the majority of jurists are agreed on its permissibility ((Arshad & Ismail, 2010). It is a joint venture or a partnership contract under *sharikatul-milk* agreement, in which, the two parties contribute capital and labour to the joint venture, but with a different capital contribution ratio (Baele et al., 2014). Moreover, *musharakah* is the most preferred Islamic financing mode due to its closeness to the principle of profit and loss sharing (Mirakhor & Zaidi, 2007). One the major difference between *musharakah* and *mudarabaha* arrangements is that, in *musharakah*, both parties make a financial contribution, whereas under *mudarabaha*, only one party provides the capital and the other part provides management skill. This is the main reason why profit-sharing ratio is based on a pre-agreed ratio and not based on capital

contribution ratio (Mirakhor & Zaidi, 2007). However, in the case of losses, the losses will be shared based only on the ratio of contributed capital.

However, the heavy dependence on Islamic debt financing instruments has become an issue, thus, scholars have tried to find ways to limit its reliance. Therefore, the *Musharakah mutanaqisah* (Diminishing Partnership) instrument was developed to reduce the high dependence of Islamic debt (Siswantoro & Qoyyimah, 2007). It is based on diminishing partnership concept, which contains three contracts, namely *musharakah*, *ijarah* and sale contracts ((Osmani & Abdullah, 2010). The process has three stages. Firstly, it occurs in a situation, where the two parties enter into a joint partnership contract and agree to contribute the capital to the jointly owned asset, but with two different ratios of ownership. Secondly, the party with the higher ownership ratio is the financier and he or she leases his/her share to the co-owner (the party with low ownership ratio) under the *ijarah* concept. Thirdly, the co-owner will buy the main owner's units within a certain period, until the lessee/co-owner fully owns the asset. The idea is this the rental payments will be jointly shared between the main and the co-owners based on their capital contribution ratios at any given time, since the ownership percentage keeps changing as the co-owner purchases more units of the main owner's share (Meera & Abdul Raz, 2009).

It should be noted that in this case the rental payment will be determined based on actual rental value of the property. This replaces the existing interest rate pricing mechanism in the conventional financial system. Moreover, the pricing based on rental value is a permissible approach in *shari'ah*, since the rental rate is a reflection of the real property value in the market. However, the arrangement raises an issue about its legality in *shari'ah*, because this arrangement is based on three combined contracts,

namely, *musharakah*, *ijarah* and sale. From the *shari'ah* point of view, each contract is separately permissible and there is no major difference among the jurists' opinions about this. The issue is whether the combined contracts for one purpose, which is making one single contract, is permissible or not. In such a case, the arrangement is not permissible in *shari'ah*. Nevertheless, if a promise is introduced in the arrangement then, it will be permissible, even though, the arrangement lacks law enforceability (Usmani, 2004). Finally, current Islamic banking practice indicates that the *Musharakah mutanaqisah* contract is widely used in home and machinery financing with the hope that it may reduce the heavy reliance on Islamic debt financing in the industry (Saad & Abdul Razak, 2013).

#### **2.2.2.1.2 Mudarabah Financing**

*Mudarabah* is a risk-return sharing financing instrument. It is similar to the concept of silent partnership in conventional finance. *Mudarabah* contract does not require forming a company (Mirakhor & Zaidi, 2007). In the *Mudarabah* arrangement, the capital provider (*rabul mal*) and fund manager (*mudarib*) agree to invest in a project for a fixed period and to share risks and returns of the project. Thereby, the profit will be shared according to a pre-agreed ratio between the two parties (Abdul-Rahman & Nor, 2016). However, in the case of losses, the loss will be borne by the fund provider based on capital contribution ratios, while the fund manager will lose the opportunity costs of time and effort, except in the case of negligence or misconduct (Hamza & Saadaoui, 2013).

In general, the equity financing lacks acceptance in the current practice of Islamic banking and Islamic capital markets. It represents a small percentage of total

Islamic financing. The global *Sukuk* structure reported that the equity-based *Sukuk* structure represents only 5.4% of total issued *Sukuk* in 2016 (Board, 2017). Moreover, Chong and Liu (2009) found that profit and loss sharing mechanism accumulated only 0.5% of total Malaysian Islamic banking financing, while the debt-based instruments dominated the field with 99.50% of total Islamic banking financing.

Since Islamic debt instruments dominated the Islamic financing instruments, the next section addresses various Islamic debt instruments.

#### **2.2.2.2 Sale-based Financing Instruments**

This sub-section discusses the Islamic debt instruments, namely, the sale-based financing modes i.e., *murabaha*, *salam* and *Istisna`* instruments.

##### **2.2.2.2.1 *Murabaha* financing**

*Murabaha* is a debt contract, in which, one party makes a promise to buy specified goods from another party based on deferred payment. Then, the later purchases the goods from its supplier and sells them to the first party at a price, which contains the original cost, plus profit margin (Hassan et al., 2013). *Murabaha* arrangement represents 46% and 95% of total Islamic financing in Malaysia and Saudi Arabia respectively (Yanikkaya & Pabuçcu, 2017). This indicates that Islamic banks and Islamic corporations rely heavily on *murabaha* in carrying out their business activities (Yanikkaya & Pabuçcu, 2017). Moreover, in the case of Malaysia, the data show that Islamic debt contributes 75% of total financing (Jusoh & Khalid, 2013).

However, this is in fact against the theoretical suggestions made by Islamic economists in the early 19<sup>th</sup> century, which encouraged equity-based financing

instruments as the best financing alternative to the current the conventional banking system financial instruments (Shinsuke, 2012). The majority of scholars disagreed with the excessive use of *murabaha* as a financing alternative due to its closeness to the conventional financing practices. Particularly, Islamic banks were highly criticised for not offering real risk transfer and the usage of interest rate as a benchmark to fix and predict the expected return rate in a *murabaha* investment. They were also blamed for charging higher return rate on long-term contracts, which is more likely similar to the current conventional financing (Zandi & Ariffin, 2012).

On the other hand, Siddiqi (2006) suggested that the introduction of *murabaha* financing instrument in the late 1970s played a significant role in the growth of Islamic banking and finance. Moreover, within a short period, it has overtaken the equity-based financing mode and given the Islamic banking and finance industry a big boost as a replacement for the conventional banking system financial instruments. As a result, *murabaha* has become the dominant Islamic financing instrument due to lack of trade financing instruments in equity financing and the issue of capital protection in equity financing. These are the main reasons that have led to the failure of equity financing instruments to compete with the conventional financing modes.

#### **2.2.2.2.2 Salam Financing**

*Salam* is a credit-based financing instrument, whereby the seller commits to supplying specific goods to the buyer on a fixed date in the future in exchange for an advanced price. It requests payment in full and on the spot (Usmani, 2012). The *Salam* contract is a permissible in *shari'ah*. It is one of a few contracts that have been exempted from the general rule of sale. It states that the producer/seller is not permitted to sell a

product, which is not in his/her position at the time of contract. This exemption has been made due to the financial needs of small businesses (Kahf & Khan, 1992).

Salam arrangement indicates that the producer has to manage the financial needs of labour and raw material costs. The advance payment gives the financier an opportunity to benefit from the cheap price of *salam* sale, which is always cheaper than the cash sale. In this arrangement, the fund provider has no right to intervene in the management process of the allocated fund and thereby, the producer is free to utilise the fund. From this perspective, *salam* arrangement is similar to the *mudarabah* arrangement, where capital providers have no rights over fund management and skill providers/*mudarib* have full authority to manage the fund (Khan, 1994).

Initially, *salam* contract was designed to finance the agricultural sector with a specified weight and for a definite time in the early days of Islam, but, in the current Islamic finance practice, it was developed to finance construction and manufacturing projects (Al Zaabi, 2010).

#### **2.2.2.2.3 Istisna` Financing**

The word “*Istisna*” is derived from “*sana`a*”, which literally means “making and manufacturing” (Borhan, 2002). It is a contract to purchase or sell goods at a specified price, which is non-existent at the time of the contract. However, it will be manufactured and delivered later at a determined time in the future in exchange for an advance price, which is payable either in full or in part on the spot (Zarqa, 1997). Moreover, in the *Istisna`* contract, both parties have a choice to cancel the contract before starting the manufacturing process, but no one has a right to cancel it unilaterally in the middle of the process (Usmani, 2012).

*Istisna`* shares similarities with the *salam* contract in terms of future delivery of the goods and the permissibility of the sale of goods, which were nonexistent at the time of the contract. This is, because both contracts are exempted from the general rule of sale, which indicates that the seller is not allowed to sell a product that is not in his/her possession at the time of the contract (Kahf & Khan, 1992). However, the major difference between the two contracts is that *salam* contract suggests that the full payment must be made in advance at the time of the contract, while in *Istisna`*, the payment can be deferred or paid in installments (Borhan, 2002). The current practice of modern Islamic banking and finance uses *Istisna`* to finance construction and manufacturing sectors in Malaysia (Bank Negara Malaysia, 2010).

### 2.2.2.3 *Ijarah* financing (Lease Financing)

*Ijarah* is a sale of *manfa`a* or “right to use an asset for a certain period”. It is similar to conventional lease financing. *Ijarah* is a contract, where one party buys and leases out an asset or equipment to another party for a specified period with a separate contract based on rental payments (Mirakhor & Zaidi, 2007).

*Ijarah* is a form of asset-based financing. The ownership of the asset remains with the lessor/financer and the lessor will be responsible for its maintenance within the predetermined lease period unless there is negligence on the part of the lessee. The leased asset serves as collateral against commercial risk of lessee, which makes *ijarah* financing instrument an attractive alternative to the interest-based financing instruments (Tahir, 2013).

In the *Ijarah* contract, it is permissible to charge rental fees, since the lessee enjoys the usufruct. In the current Islamic banking system, *Ijarah* is applied to finance

housing, cars, telecommunication equipment, industry and manufacturing sectors (Ebrahim & Sheikh , 2011). Moreover, *Ijarah wa'Iqtina* instrument also is similar to normal *Ijarah* arrangement, but it allows that lessee to own the leased asset at the end of the period either through a “free gift” arrangement or as per-agreed price agreement (Bael et al., 2014).

In the Part 2 of this chapter, more emphasizes were given to the Islamic financing instruments from equity, sale and *ijarah*/lease-based financing instruments. This is order to provide a clear idea about the adopted Islamic financing instruments in *shariah*-compliant companies, which are the sample of the current study. In part of the research objectives of this study, it aims to investigate the effect of interest-bearing debt and Islamic debt on the performance of *shariah*-compliant companies applying separated debt data. Therefore, it is very crucial to study the Islamic financing alternatives in order to separate the type of debt instruments and its data.

### 2.3. Conclusion

This chapter reviews the development of *shari'ah* stock screening in Malaysia, International standard *shari'ah* stock screening, *shariah* rulings for mixed companies and the foundation of the benchmark of one-third. The chapter also details the Islamic financial instruments, which contains three types of financing i.e., equity-based financing, debt-based financing and *Ijarah*/ lease-based financing. This is crucial component in the understanding of current *shari'ah*-compliant companies' financing polices known as debt-equity structure.