CHAPTER 1

INTRODUCTION

In this first chapter of the thesis, the following are presented: the introduction to the study, the background of Islamic financing, followed by the problem statement of the study, then the research objectives and the research questions. The research framework is then described, followed by the significance of the study, the scope of the study and concluding with the organization of the thesis comprising brief outlines of the thesis chapters.

1.1 Introduction

Literature on capital structure mainly explain mixed securities and financing sources that corporate managers use to finance their real investments. It has focused on debt-equity choices, which are extremely crucial in corporate financing policies (Myers, 2001). This is because changes in debt-equity structure convey information to investors, which may be perceived as either good news or bad news (Myers, 1984). Historically, the debate of capital structure theories was initiated by Modigliani and Miller's seminal paper in 1958. They stated that "debt-equity choices have no effect on the value of the firm or on the cost of the capital, assuming that there are no taxes, no transaction costs/no brokerage costs, no bankruptcy costs and existence of symmetric information." Meanwhile, the firm's value will be independent of its method of financing i.e., debt-equity structure in a perfect capital market. Hence, both leveraged and unleveraged companies remain equal and will remain in equilibrium regardless of their debt-equity

choices (Modigliani & Miller, 1958). However, modern capital structure theories have presented a different view regarding the debt-equity choices. They emphasised that financing still matters due to the presence of taxes, the differences in information and the agency costs with the assumption that the capital market is imperfect (Myers, 2001).

Moreover, the debate of Irrelevance Theory's assumptions has resulted in the development of modern capital structure theories, namely, Modigliani and Miller (MM) Trade-off Theory, Static Trade-off Theory, Pecking Order Theory, Agency Cost Theory, Signalling Theory and Market Timing Theory. The MM Trade-off Theory is due to the recognition of corporate tax's effect on firm value, which was one of the Irrelevance Theory's assumptions. The theory suggests that a leveraged firm enjoys tax benefits due to the interest payment, which is a tax-deductible expense compared to its counterpart/unleveraged firm (Modigliani & Miler, 1963). This theory implies an extreme assumption of 100% of debt financing for value-maximisation companies, which is not in line with what the practical work suggests (Berens & Cuny, 1995, and Luigi & Sorin, 2009). This is because, there are different costs that are related to the benefits of debt financing including bankruptcy costs i.e., auditing costs, legal costs, and management costs (Berens & Cuny, 1995). This has led to the development of Trade-off Theory.

The consideration of bankruptcy costs, which is ignored in MM Trade-off Theory, is the leading factor in the development of Static Trade-off Theory, which is one of the long-standing capital structure theories (Abel, 2015). It also justifies moderate borrowing by a tax-paying firm at which a firm can balance the corporate tax benefits of debt financing against the bankruptcy costs (Berens & Cuny, 1995, and Myers, 2001). In this theory, the firm is viewed as setting a debt-equity target. Thus, it

gradually moves towards that target, where the firm replaces debt for equity or equity for debt, until the firm reaches at the maximisation point/the optimal debt-equity ratio (Myers, 1984). The Static Trade-off Theory suggests that "a value-maximising firm should gain any interest tax shield, when the possibility of financial distress is remotely low." However, the theory fails to explain why well-established and profitable companies, for example, Microsoft and the major pharmaceutical companies in the United States are still operating at low debt ratio (Myers, 2001).

This is the primary reason that led to the birth of Pecking Order Theory (POT), which has its basis in asymmetric information assumption. The theory, as explained by Myers (1984) states that "firm managers prefer internally-generated funds i.e., depreciation and retained earnings over externally- raised funds and within the external funds, they issue the safest security first, which is in this case, debt, then equity as a last resort". This theory suggests that the changes in debt-equity structure are due to deficit of internally-generated funds (Shyam-Sunder & Myers, 1999). This theory does not have a clearly defined target of debt-equity ratio. The benefits of debt and the costs of bankruptcy are placed as a second order (Zhang & Kanazaki, 2007). They found that the POT suggests that "high profitable companies with limited investment opportunities prefer using internal cash flow, while low leveraged companies with huge growth opportunities and shortage of internally-generated funds prefer debt financing" (Myers, 2001).

However, the Agency Cost Theory (ACT) analyses the conflict of interest between firm's managers and its shareholders. Corporate managers are the agencies of shareholders and the conflict of interest arises between the two parties (Jensen, 1986). This is mainly because the firm's managers in fact have full control over the resources

of the firm (Fosberg, 2004). Therefore, the creation of debt is considered as an advantage and a useful policy to limit firm manager's control. The debt also reduces the free cash flow problems, which may lead to investing fund at below capital cost or wasting it on organisational inefficiencies (Jensen, 1986). They argued that there are some advantages of having debt as a source of funds. First, it reduces the availability of free cash flow to spend at the manager's discretion. Second, failure to service the debt payments is an effectively monitoring tool to make such organisations improve efficiency. However, the control function of financing debt will become less effective in organisations that generate less cash flow with higher growth opportunities (Jensen, 1986).

Signalling Theory (ST) is one the modern capital structure theories. It is all about making certain changes in the debt-equity structure of a firm to send a reliable signal to the firm's outsiders regarding its financial health and its future cash flow, i.e., the principal and interest payments. The theory argues that increasing the leverage ratio of a firm raises its value and it consequently increases its market share price, implying that firm managers have better information than its potential investors do (Ross, 1977). In signalling hypothesis, the increasing leverage is considered as an effective signaling policy for firm quality. Therefore, in this theory, debt financing is the preferred mode (Eldomiaty et al., 2005).

Finally, the Market Timing Theory (MTT) argues that "capital markets are imperfect, in which, there will be a gain from opportunistically switching between equity and debt". The theory is based on equity market conditions, in which, a firm issue shares at high prices and it repurchases them at low prices relative to book value and past market values. This theory has no best capital structure target and changes in debt-

equity structure are largely due to the collective result of prior efforts to time market equity (Baker & Wurgler, 2002).

It is worth noting that the modern capital structure theories were created relative to one of Irrelevance Theory's assumptions. Therefore, the TOT highlights taxes, the POT highlights variances in information and the ACT stresses agency costs (Myers, 2001). As the review suggests, MM Trade-off Theory focuses on tax advantages (Modigliani & Miler, 1963), while the ST emphasises the choice of debt as an indication of firm quality (Ross, 1977) and the MTT emphasises the differences in information (Harris & Raviv, 1990).

Overall, the modern capital structure theories mainly attempt to address the best blend of debt-equity ratio that make the most of the firm's market value and exploits the cost of financing (Alipour et al., 2015). The choice of debt equity remains a significant factor. This is because, the capital structure decision represents the greatest challenge to firm managers in terms of selecting the debt-equity ratio that balances the advantages and the disadvantages of having debt as a source of financing (Morri & Cristanziani, 2009). This study focuses on the TOT in the interoperation of the expected findings of the study and mainly its hypotheses development.

Besides on that, the debate produced a huge body of empirical literature, which examines the existing capital structure theories. However, the vast majority of studies have ended up with mixed findings (Eriotis et al., 2007). On the other hand, each one of the modern capital structure theories explains only part of corporate financing decision making behaviour, which leads to the conclusion that there is no single universal capital structure theory that can elaborate the behaviour of firm managers towards debt equity choices (Myers, 1984). This is, in fact, one of the reasons that

encourages today's researchers to conduct further research and to assess the effect of debt-equity ratios on firm value as discussed below in the problem statement section.

On the other hand, the re-emergence of Islamic finance (IF) over the past five decades has prompted an alternative capital structure for *shari'ah*-compliant companies, which offers various financing sources i.e., profit-loss sharing instruments and debt-based financing instruments namely sale-based financing and lease financing instruments, even though the sampled data indicate that the *shari'ah*-compliant companies mainly rely on Islamic debt financing instruments rather than profit-loss sharing instruments.

In terms of Malaysian financial system, Malaysian Islamic Finance Industry contains three major parts namely Islamic financial institutions, Islamic capital market and Takaful. *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.

The idea of having a *shariah* screening criteria dates back to 1987. This is in order to provide financial instruments alternatives, which allow Muslim investors to own shares from one of the listed securities on the capital markets (Adam & Bakar, 2014). Therefore, number of *shariah* screening indicts were developed, which is based on qualitative and quantitative approach in determining the status of a firm. There is general agreement within the *shariah* screening indicts toward the

qualitative approach, however, there are differences in setting up the quantitative ratios/financial benchmark ratios across *shariah* indices.

Regarding the existing studies, the extant literature pertaining to capital structure has largely focused on the role of "conventional" capital structure in corporate value. The overarching goal of this research, therefore, is to explore the effect of total Islamic leverage, interest-bearing debt ratios, which falls within the *shari'ah* -compliant company's criteria of 33% of firm's total assets and Islamic debt ratios on *shari'ah*-compliant companies' performance and to examine further the optimal level of total Islamic leverage at which a *shari'ah* company can maximize its performance.

Moreover, in this context, the total Islamic leverage is measured as the total debt containing both types debt i.e., total Islamic debt and total interest-bearing debt. It is the ratio of total Islamic leverage to a *shariah* firm's total assets. While interest-bearing debt is the conventional debt, which is within the range of 33% of firm's total assets. It is the ratio of total interest-bearing debt to *shariah* firm's total assets. The Islamic debt contains sale and *ijarah* based contacts i.e., *murabaha*, *Ijrah* and *salam* financing. Therefore, total Islamic debt is measured by total Islamic debt to *shariah* firm's total assets. This is due to the fact that the study aims to conduct a deep analysis in terms of examining separately the effect of Islamic leverage ratios on Malaysian *shari'ah*-compliant companies' performance particularly before and after the changes in *shari'ah* screening guidelines in 2013 toward the financial ratio benchmarks.

1.2 Background of Islamic Financing

Unlike the traditional corporate capital structures, which are based on conventional theories, Islamic finance (IF) drives the overall economic activities and enhances production level as Islamic teaching suggests (Yusoff, 2006). In IF, all transactions should to be governed by *shari'ah* principles. Furthermore, the *shari'ah* law requires every transaction to be on a just and fair basis to all involved parties (Najeeb, 2014). On the other hand, the *shari'ah* also imposes restrictions on some economic activities, which, according to Usmani (2004) include: "prohibition of *riba*/interest, gambling, hoarding, dealing with illegal merchandise or services, short sales and speculative transactions." *Riba*/interest is related to financial transactions. It is described by Gunn and Shackman (2014) as "unjustified enrichment and it should be eliminated from the exploitation of business operations for *shari'ah*-compliant companies. It is categorised as an amount that was predetermined and fixed at the beginning of the contract."

Alternatively, *shari'ah* provides three major financial instruments, which are equity-based financing, sale-based/debt-based financing and *Ijara*/lease-based financing. In principle, *Islam* always promotes the equity financing mode, in which, both parties namely shareholders and creditors act as partners through profit and loss sharing mechanisms i.e., *mudarabah* and *musharakah*. Because these two financial instruments are the best to avoid interest in dealing with financial transactions and work to eliminate the interest particularly from the financial field and generally from all economic activities (Khan & Bhatti, 2008).

However, *shari'ah* also permits debt-based financing such as a *murabaha* contact, which offers an additional financial instrument, which may participate in

enhancing the current practice of Islamic banks and *shari'ah*-compliant companies. Most importantly, adopting various types of Islamic financial instruments is crucial to improve the risk management level for both Islamic corporations. Nevertheless, the vast majority of Islamic jurists still have a negative view of the heavy dependence on Islamic debt instruments due to their similarities with the conventional financing instruments (Ahmed, 2006).

Moreover, the equity-financing mode, which is based on *musharakah* and *mudarabah,* is considered the ideal financing instrument in a debt-free financial system. Because, it is based on profit-loss sharing mechanism, which should be the outcome of any investment, not based on a pre-determined/fixed rate as in the case of conventional financing practice. Therefore, the equity-financing was expected to be the major financing instrument for *shari'ah*-compliant companies (Jusoh & Khalid, 2013). However, Islamic debt financing instruments such as *murabaha* and *Ijarah* financing have overtaken the equity-based financing instruments and become the dominant financing instruments (Jusoh & Khalid, 2013). Therefore, the issue is that the replacement of the overwhelming use of Islamic debt financing instruments in the current Islamic financing system with the preferred profit and loss sharing financing modes will remain the greatest challenge that faces today's *shari'ah*-compliant companies worldwide.

Besides, the majority of *shari'ah* screening indexes have allowed Islamic corporations to use a certain percentage of pure conventional debt in part of their capital structure portfolio within the range of 30 to 40% of total assets (Ho, 2015). However, in Malaysian context, this ratio was set to be either equal to or less than 33% of firm's total assets (Securities Commission Malaysia, 2017). This is the newly adopted

financial benchmark ratio, which is the maximum allowed conventional debt ratio as a source of financing within the *shari'ah*-compliant guidelines, meaning that this threshold does not include Islamic debt percentage raised through *murabaha*, *ijarah* and *sukuk* financing in the overall debt-equity structure of a *shari'ah* firm ((Zainudin et al., 2014).

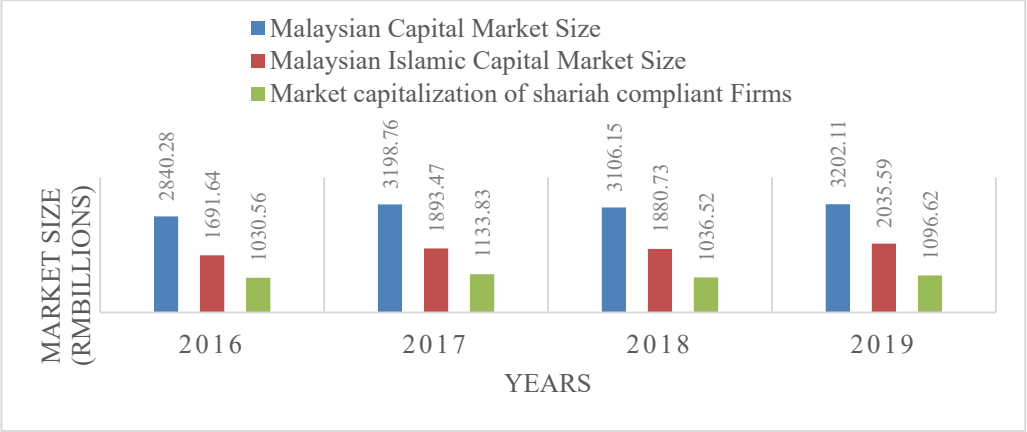
On the other hand, there is no such upper ratio in Islamic leverage in IF. In this case, the Islamic leverage contains both types of Islamic debts namely Islamic debt and conventional debt, which is within the range of 33% of firm's total assets. Therefore, *shari'ah*-compliant corporations enjoy more flexibility in respect of the ratio of Islamic leverage as a financing source. Due to this, *shari'ah* companies have a diverse range of debt financing instruments from Islamic debt, which are based on sale or *ijarah* bases, to interest-bearing debt/limited conventional debt within the 33% criteria, which put them in a position, where, *shari'ah*-compliant companies' managers have more choices in selecting the components of their debt-equity structure. Hence, Islamic debt financing becomes an important part of the capital structure of *shari'ah*-compliant companies, which may have an impact on their performance.

Given this, it is a fundamental to note that *shari'ah*-compliant companies are operating in a financial environment, which is more or less similar to the conventional financial market in terms of regulatory framework that governs the recognition of taxes, bankruptcy costs, financial distress costs, transaction costs, agency costs, alongside the asymmetric information (Obaidullah, 2007). This is another reason, which led to the perception that the Islamic leverage may affect the way *shari'ah*-compliant companies perform. Thus, it is highly important to examine the effect of total Islamic leverage, interest-bearing debt ratios and Islamic debt ratios on how continuously listed *shari'ah*-

compliant companies on the main market of Bursa Malaysia perform and study further the optimal level of total Islamic leverage for *shari'ah*-compliant companies.

1.3 The Problem Statement

It is highly crucial to emphasize that the *shari'ah*-compliant companies are a significant component of the Malaysian Islamic Capital Market (ICM) and overall Malaysian capital market. As can be seen, figure 1.1 reveals the *shari'ah*-compliant companies contribute an average of 57% of the total Malaysian Islamic capital market and 35% of overall the size of the Malaysian capital market.



Source: Bursa Malaysia, FAST BNM

Figure 1.1: The proportion of *shari'ah*-compliant companies Vs Islamic capital market and the overall size of the capital market in Malaysia.

Besides that, the *shari'ah*-compliant companies make up 76% of the total traded securities, which are more than two-thirds of listed securities on the Main Market of Bursa Malaysia (Securities Commission Malaysia, 2017). This rapid growth is in line with the existing Malaysian policies that advocate Malaysia as a global hub for Islamic

finance and as a world-class centre for Islamic fund administration (Centre for Islamic Asset and Wealth Management, 2018).

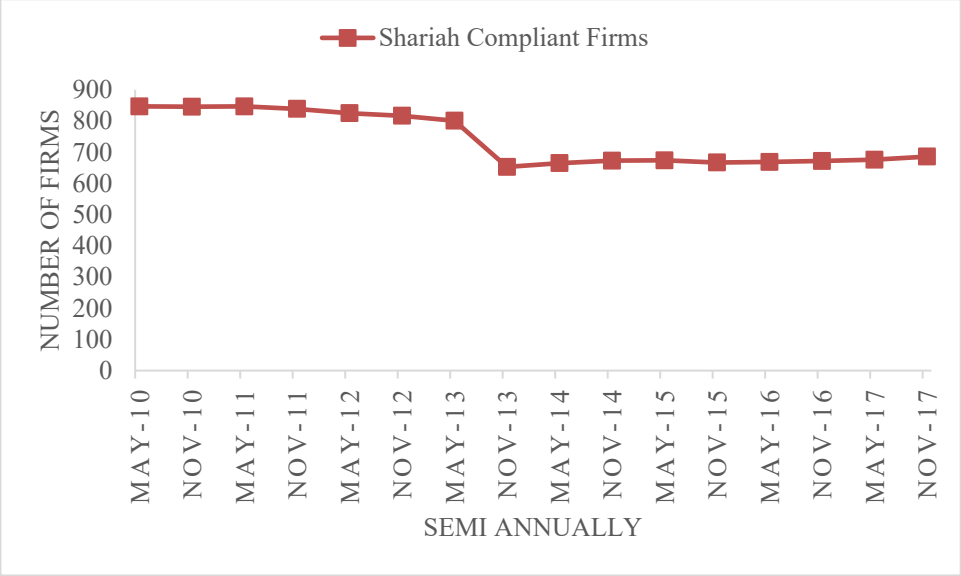
With this in mind, the field still lacks studies, which particularly address the impact of interest-bearing debt ratios and Islamic debt ratios on how *shari'ah*-compliant companies perform, which are and will remain major components of the Islamic Capital Market in Malaysia using separate debt data. Interest-bearing debt is a pure conventional debt, which ranges from zero to 33% of firm's total assets. This is because based on the latest revised *shari'ah*-screening methodology, a *shari'ah*-compliant company is permitted to have a maximum of 33% of its total assets from conventional debt as source of financing, which is the criteria for *shari'ah*-compliant companies (Securities Commission Malaysia, 2017). This is based on the concept of *Ijtihat*, which is derived from the words of prophet Muhammad (PBUH), which were "one-third is enough", whereas with its counterpart, which is Islamic debt. It is a debt, which is raised using one of Islamic debt financing instruments such as *Sukuk Ijarah* MTN, *Bai' Bithaman Ajil*, Islamic facility, *Al-Istisna*, Islamic medium-term, *Sukuk Ijarah* and *Murabahah* medium-term notes.

It is highly important to realise that the *shari'ah*-compliant companies operate in a very restricted regulatory framework with regard to debt-equity choices particularly, the element of conventional debt due to the involvement of interest rate, which is not allowed in Islam. In the best scenario, the *shari'ah* companies are allowed to generate a maximum of 33% of a firm's total assets from conventional debt as source of financing, which is a benchmark for *shari'ah*-compliant companies. This is based on the revised financial ratio benchmarks introduced in November 2013 (Securities Commission Malaysia, 2017). This is part of the SCM's polices, intend to standardise

the *shari'ah*-screening methodology to attract Muslim investors worldwide (Ayedh, Kamaruddin & Shaharuddin, 2019). On the other hand, non-*shari'ah* companies enjoy flexibility in debt-equity choices, involving a trade-off between tax benefits and financial distress costs (Ross et al., 2009). Sometimes, non-*shari'ah* companies prefer debt over equity due to a taxi-deductible expense (Myers, 2001). Therefore, this study interested to investigate the effect of conventional debt limitation on *shari'ah* company in the new *shari'ah*-screening methodology addressing its impact before and after its revisal of financial ratio, which was introduced in November 2013. Thus, the study is in attempt to produce comparison study to analyse the effect of Islamic leverage ratios before and after the changes in *shari'ah*-screening methodology, which particularly limit the ratio of conventional debt to or less than 33 % of firm's total assets.

The two-tier quantitative approach argues that the *shari'ah*-compliant companies' business activity and financial ratios must stay within the stated ratio to maintain the *shari'ah* status. This new financial threshold, thus, limits the ability of *shari'ah* companies to raise interest-bearing debt as a source of financing to the 33 % of firm's total assets and this leads to a greater concern that the new threshold of financial ratio may affect the performance of *shari'ah*-compliant companies measuring its effect before and after its adoption in November 2013. In this regard, it is particularly worth mentioning that this is a rapidly growing concern because the revised financial threshold has caused a reduction in the total number of listed *shari'ah*-companies as Figure 1. 2 shows. Figure 1.2 reveals the historical data of total *shari'ah* companies for the period of 2010 to 2017. The figure also indicates the number of listed *shari'ah*-compliant companies showed a sharp drop in November 2013 and following that, which averaged 130 companies representing a 16% loss of total *shari'ah* companies, due to

the newly-imposed 33% of firm's total assets as a maximum ratio for conventional debt financing, which is the criteria for *shari'ah*-compliant companies. This sudden drop raises real concerns about the revised threshold affecting the performance of continuously listed *shari'ah*-compliant companies on the Main Market of Bursa Malaysia.



Source: Securities Commission Malaysia Reports

Figure 1.2: The *shari'ah* companies and the effect of the revised financial ratio Benchmark

The revised financial ratio benchmark for *shari'ah*-screening methodology was the main reason that led Nor, Shaharuddin, Marzuki and Ramli (2019) to conduct a study, which investigated the impact of recent new changes in *shari'ah* screening methodology on the share prices of the affected companies and the Islamic capital market in Malaysia. This study also was motivated by the revised financial ratio benchmark, which had real time effect on the total number of listed securities on the Main Market of Bursa Malaysia. Therefore, with the new screening methodology, this

study examines the effect of the revised conventional debt ratios on the way *shari'ah*-compliant companies performed in Malaysia and measure its effect on firm performance before and after the new ratio was adopted in November 2013 to conduct a comparison study, which addresses the effect of changes in financial ratio benchmark for conventional debt financing.

This new threshold has limited firm's access to interest-based debt compared to the old *shari'ah* screening methodology of the SCM. As such, the current *shari'ah* -screening guideline implies that *shari'ah*-compliant companies have open access to raise unlimited Islamic debt as a source of financing, while its counterpart/conventional debt's access is limited to equal to or less than 33% of firm's total assets as discussed earlier. The question asked is whether there is an optimal level of total Islamic leverage for *shari'ah*-compliant companies, where their performance may optimise by maximising the ratio of Islamic leverage. It is highly risky to go with 100% of Islamic debt financing. This will be in a situation, where a *shari'ah* company raises a maximum of 33% from interest-bearing debt and 67% from Islamic debt, which is highly rare in the practical world as the MM tradeoff theory suggests due to a bankruptcy risk (Modigliani & Miler, 1963). On the other hand, one key requirement of Islamic debt is that debt must be backed by assets, thereby, company cannot issue debt, which is more than its assets (Ahmed, 2007). According to the current *shari'ah* screening methodology, the ratio of interest-bearing debt should be within the range of zero to 33% of a *shari'ah* company's total assets (Securities Commission Malaysia, 2017). Under the trade off theory, a firm replaces debt to equity and equity to debt until it reaches certain point at which it can maximize its performance. Using debt as source of financing has the benefits of tax deductions, in this, the study assumes that that *shari'ah*-

compliant companies are tax-benefits oriented, where they prefer debt financing over equity due to tax benefits. Therefore, this study also investigates the optimal level of total Islamic leverage for *shari'ah* companies, which are a significant proportion of the total Islamic capital market in Malaysia and Malaysian capital market.

The final point is that it is six decades since the first debate of capital structure theories took place in 1958 (Modigliani & Miller, 1958). This led the capital structure to been one of the major fields in corporate finance, which has been widely studied. However, the puzzle of capital structure is still ongoing. This is mainly because, according to the existing literature, it is very challenging to draw a fair conclusion about a single universal capital structure theory that can elaborate debt-equity choices, because each theory of capital structure emphasises one of Irrelevance Theory's assumptions (Myers, 2001).

In addition, Al-Najjar and Taylor (2008) reached a similar conclusion with regard to debt-equity choices stating that there is no clear theoretical explanation about how companies decide on different sources of financing. This in part contributes to the puzzle remaining largely unanswered (Sukor, Halim & Bacha, 2018). Therefore, this study analyses the result of both debts, i.e., interest-bearing debt and Islamic debt in relation to a *shari'ah* company's performance and it further relates the expected outcome to the main adopted theory of existing capital structure theories namely TOT, which may assist in interpreting its findings. Because it is highly significant to note that this research applies separated debt data, namely interest-bearing debt and Islamic debt, which may result in two different relationships/dimensions, i.e., positive and negative, with *shari'ah* company performance as the pilot data implies, which is based on 30 constantly listed *shari'ah*-compliant companies.

However, the prior empirical studies have ended up with mixed results pertaining to the relationship between debt and firm performance (Asimakopoulos et al., 2009). These inconclusive results from capital structure studies are still unresolved to date, mainly because the empirical studies have been conducted in various countries, where companies are operating under different regulatory frameworks and market development levels including developed and emerging countries. Most importantly, the existing empirical studies have adopted a diverse set of methodologies and various leverage and performance measurements, leaving the debate of capital structure choices subject to future investigation (Haron, Ibrahim, Nor & Ibrahim, 2012). This is particularly important to note because the current study adopts new leverage measurements such as interest-bearing debt and Islamic debt, which are not discussed in the existing literature, and this may lead to a different outcome with regard to Islamic leverage and firm performance.

It is also worth reporting that few research have been carried out on capital structure and *shari'ah*-compliant companies in Malaysia (Sadeghi, 2008), (Thabet & Hanefah, 2014, Yildirim et all., 2017, and Ramli & Haron, 2017). These studies also applied the common standard of debt as reported in Datastream and Bloomberg databases, which use a combined debt data without defining/separating the proportion of interest-bearing debt from Islamic debt (Ramli, 2018). This is because, these global databases do not follow the *shari'ah*-screening methodology in reporting the debt data and instead they combine both interest-bearing debt and Islamic debt data and report them under one category, namely short-term and long-term borrowing or loan. Therefore, applying the combined debt data may lead to biased results and produce inaccurate and misleading findings regarding *shari'ah*-compliant companies and

performance evaluation. As the existing studies show, applying combined debt data results in a one-direction relationship i.e., positive or negative between debt financing and firm performance, while the pilot data reveals new details, which indicate each type of debt may result in two different relationships, with *shari'ah* company performance. Therefore, this is in part what motivates this study to conduct this research, which takes these issues into account and apply a separated interest-bearing debt data and Islamic debt data according to Malaysian *shari'ah*-screening methodology.

Within this context, it is also vital to address the behavior of *shari'ah* -compliant companies towards the type of debt, i.e., interest-bearing debt and Islamic debt or the length of debt period such as short or long-terms. This will provide some idea about *shari'ah* companies' financing behavior and the cost of financing and the level of Islamic capital market development.

Therefore, given the significance proportion of *shari'ah*-compliant companies in the Malaysian Islamic capital market and the recent revised financial ratio benchmark of the SCM and the scarcity of studies on Islamic leverage and *shari'ah* companies' performance, this study steps in and examines the effect of interest-bearing debt ratios before and after 2013 and Islamic debt ratios on *shari'ah*-compliant companies' performance using separate debt data and it further studies the optimal level of total Islamic leverage at which a *shari'ah* company may maximise its performance.

It is very crucial to note that this study mainly focuses on continuously listed *shari'ah*-compliant companies on Main Market of Bursa Malaysia implying that the study exclusively selects Malaysia as a sample of the current study due to data availability for number of years, market size, number of companies in contrast with

UAE, a prominent centre of Islamic finance in GCC counties (Dubai Financial Market, 2021).

1.4 Research Questions

In order to respond the issues stated in the problem statement these following questions are formulated:

1. Does total Islamic leverage affect the performance of *shari'ah*-compliant companies' performance in Malaysia measuring the effect of the new implementation of financial benchmarks in 2013?
2. Do various debt ratios i.e., short-term interest-bearing, long-term interest-bearing, total interest-bearing debt and short-term Islamic, long-term Islamic, total Islamic debt impact the performance of *shari'ah*-compliant companies in Malaysia by incorporating the effects of the new implementation of financial ratio benchmarks in 2013.?
3. Does the optimal level of total Islamic leverage affect the performance of *shari'ah*-compliant companies in Malaysia?

1.5 Objectives of the Study

The study aims to investigate the effect of interest-bearing debt ratios before and after 2013, -which is the year, where the financial benchmarks are introduced- and Islamic debt ratios on the performance of continuously listed *shari'ah*-compliant companies on the Main Market of Bursa Malaysia using separate debt data. The study further investigates the optimal level of total Islamic leverage at which a *shari'ah*-compliant company maximizes its performance.

The study particularly addresses the following research objectives:

1. To analyze the effect of total Islamic leverage on *shari'ah*-compliant companies' performance in Malaysia measuring the effect of the new implementation of financial benchmarks in 2013.
2. To examine the effect of various debt ratios i.e., short-term interest-bearing, long-term interest-bearing, total interest-bearing debt and short-term Islamic debt, long-term Islamic debt, total Islamic debt ratios on the *shari'ah*-compliant companies' performance in Malaysia by incorporating the effects of the new implementation of financial ratio benchmarks in 2013.
3. To investigate the optimal level of total Islamic leverage and its impact on *shari'ah*-compliant companies in Malaysia at which a *shari'ah* company may maximise its performance.

1.6 Significance of the Study

Generally, it is important to mention that the *shari'ah*-compliant securities' funds have grown globally. The Malaysian *shari'ah*-compliant securities have experienced rapid growth in terms of number of listed *shari'ah*-compliant securities and its market capitalisation, which helps participants to boost the size of both the Islamic capital market and the capital market in Malaysia as revealed in Figure 1. 2. The Securities Commission Malaysia (2017) has reported that *shari'ah*-compliant companies represent almost 76 % of total listed securities on the Main Market of Bursa Malaysia, which is one of the vital components of Islamic capital market in Malaysia.

Therefore, this study mainly aims to address this significant aspect of the Islamic capital market. It particularly addresses the equity market/ securities namely the listed

shari'ah-compliant companies singling out the crucial part of Islamic leverage in the performance of *shari'ah*-compliant companies. The area becomes very interested field since the implementation of financial benchmarks in s*hariah* screening methodology were adopted in November 2013. It has led a loss of 130 *shari'ah*-compliant companies due to implementation of the new s*hariah* screening guidelines. This has created huge concern that the upper limitation of interest-bearing debt may have an effect on the performance *shari'ah*-compliant companies. It also examines the effect of total Islamic leverage, interest-bearing debt ratios and Islamic debt ratios on continuously listed *shari'ah*-compliant companies' performance in Malaysia and it further investigates the optimal level of total Islamic leverage of continuously listed *shari'ah*-compliant companies using separated debt data. Due to the nature of the data of the current study, this study provides recommendations and policies to regulators, government authorities, policy makers, shareholders, credit providers, investors, participants and academic researchers it presents ways to improve Islamic leverage ratio in debt-equity structure of *shari'ah*-compliant companies.

In terms of policies, the study reveals that the sampled *shari'ah*-compliant companies are equity-based financing and hence, the study recommends the regulators in financial industry i.e., Bank Negara and Securities Commission Malaysia to review the factors that discourages the listed *shari'ah*-compliant companies to adopt an Islamic leverage at significant ratio. On the other hand, *shari'ah*-compliant companies being rely mainly on equity implying that the bankruptcy issue is rare, which sends a positive to the credit providers and protentional investors.

In terms of literature, the study contributes to the existing body of knowledge for four major aspects:

Firstly, this study provides new insights into the analysis of debt financing and firm's performance. Towards this end, this study investigates the effect of interest-bearing debt ratios on continuously listed *shari'ah*-compliant companies' performance measuring the effects of the newly adopted financial benchmark before and after 2013. Secondly, the study also examines the effect of Islamic debt ratios on continuously listed *shari'ah*-compliant companies' performance using separated debt data.

Thirdly, this study applies very strict criteria in respect of the sample collection compare with previous studies. It requires that *shari'ah*-compliant companies should be continuously reported in every semi-annual report of the SCM during the study period to ensure the quality of data. It adopts separated Islamic leverage debt, which examines separately the effect of interest-bearing debt and Islamic debt on the performance of *shari'ah*-compliant companies, which was ignored in the previous studies. Because, the existing studies applied common debt data as it is reported in financial databases, which contains both conventional and Islamic debts. Finally, the study conducts a comprehensive analysis, which enhances the current practice of capital structure of *shari'ah*-compliant companies. It will provide some recommendations to the listed *shari'ah* companies' managers, shareholders, creditors, regulators, and policy makers, which may enhance the performance of *shari'ah* -compliant companies.

1.7 The Scope of the Study

It is significant to mention that the Malaysian authorities have developed a number of *shari'ah* regulatory bodies to islamise its financial institutions. For instance, the Malaysian authorities have created the *Shari'ah* Advisory Council (SAC) under the SCM. This body is tasked with categorizing the listed securities on Bursa Malaysia into

shari'ah and non-*shari'ah*-compliant securities based on the two-tier quantitative approach and qualitative assessment of *shari'ah* screening methodologies. Subsequently, the concerned regulatory body publishes a semi-annual report in May and November of each year, updating the status of listed securities on Bursa Malaysia. Besides that, the body provides historical data about *shari'ah* and non-*shari'ah* compliant securities in Malaysia. Therefore, this study primarily addresses the effect of total Islamic leverage and the impact of interest-bearing debt ratios and Islamic debt ratios on continuously listed *shari'ah*-compliant companies' performance in Malaysia and it further investigates the optimal level of Islamic leverage at which *shari'ah*-compliant companies may attain optimal performance.

1.8 Organisation of the Thesis

The thesis comprises six chapters. Chapter one presented the introduction which included the background of the study, the problem statement, the research objectives as well as the research questions. These were followed by a discussion of the significance of the study and then the scope of the study with this section on the organisation of the thesis to conclude the chapter. Chapter two provides a comprehensive review of *shari'ah*-screening in Malaysia and Islamic financial instruments, while chapter three is the literature review, which focuses on the historical development of capital structure theories and the empirical studies of capital structure and firm performance. Chapter four details the procedure of data collection, sampling criteria and the research methodology. In chapter five, the focus is on the results analysis, while chapter six provides the conclusions of the study along with implications, limitations and recommendations for related future research.