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EXPLORING APPLICATION OF EQUITY-BASED FINANCING THROUGH *MUSHĀRAKAH MUTANĀQIṢAH* IN ISLAMIC BANKS IN MALAYSIA: PERSPECTIVE FROM THE INDUSTRY PLAYERS

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ABSTRACT

Due to the prohibition of interest in Islamic financial transactions as well as the nature of the Islamic banks which is based on the profit and loss sharing concept, the equity-based financing should be widely adopted rather than debt-based financing which is similar to that of the conventional banks. As such, financing instruments such as *Muḍārabah* and *Mushārakah* are supposedly the major financing instruments offered by the Islamic banks. However, as argued in previous studies, the Islamic banks today are concentrating more on debt-based financing, particularly *Murābaḥah* and *Ijārah* contracts. Based on survey questionnaires on sixteen Islamic banks in Malaysia, this study examines the perceptions of the Islamic bankers with regard to issues on concept, pricing and compliance to *Sharīʿah* of equity-based financing in Islamic banks in Malaysia. It also investigates the challenges faced by Islamic banks in adopting equity-based financing, and examines the current practice of *Mushārakah Mutanāqiṣah* principle that has been applied by a few Islamic banks in Malaysia. Based on the findings of this study, the respondents generally agree that the principle of profit and loss sharing element under equity-based financing represents the true spirit of Islamic banking practices. However, due to constraints arising from the complex nature of equity financing products compared to conventional debt-based products, the Islamic banks are hesitant in applying the true concept of equity financing. Several recommendations on the possible ways to gradually shift from debt-based financing to equity-based financing are suggested, particularly on the needed financial infrastructure to support adoption of the equity-based financing by the Islamic banks.

JEL Classification: E44, G21, Z12

Keywords: Debt-based financing, Equity-based financing, Islamic banks, Malaysia

1. INTRODUCTION

Islamic banking and finance is currently experiencing rapid growth following increased demand for Islamic banking products and services locally and globally. Amid the encouraging growth, there has been stiff competition among the industry players in capturing greater market share, while countries are intensifying their efforts to become the industry leader and the global hub for the Islamic banking and finance industry.

Despite being in existence for more than 40 years, Islamic banking is still far from the ideals as proposed by Islam. Conceptually, Islamic banking and finance is synonymous with interest-free and profit and loss sharing with distinct characteristics from the conventional finance which predominantly offer interest-based debt instruments (see, for example, Ahmed, 2001; Dusuki, 2008; Rosly and Bakar, 2003; Siddiqi, 1985; Siddiqui, 2002). However, based on the current industry trend, the Islamic banks in general are offering products and services that have quite similar structures to those of the conventional banks. The Islamic banking products have been predominantly debt-based and various unresolved issues have hampered the efforts to shift to equity-based products.

Several reasons could be contributing to the hesitation of the Islamic banks to adopt the equity-based financing in the current context of banking. First, it is argued that the credit risk of equity-based financing is relatively higher than that of debt-based financing. This is due to the problems of adverse selection and moral hazard bringing about by the asymmetric information in the financial markets as banks do not have sufficient information on the actual profit of the entrepreneur (Khan and Ahmed, 2001). Naturally, both *Muḍārabah* and *Mushārakah* require substantial trust between the banks and their customers. In the profit and loss sharing contract of *Muḍārabah* financing, for example, a bank acts as a capital provider, while the management aspects of the business are entrusted to the customers, an arrangement which requires high level of honesty and integrity. Second, issues also arise in the monitoring and supervising aspects, in which *Mushārakah* in particular requires more commitment and effort from the banks compared to other forms of financing as the bank assumes business as well as credit risks. Third, the issue of collateral renders equity-based financing as having greater risks compared to debt-based financing. Specifically, given that both *Muḍārabah* and *Mushārakah* are equity financing in nature, collateral is not a prerequisite.

Against this backdrop, this study aims at exploring the perceptions of Islamic bankers on issues related to concept, pricing and *Sharīʿah* compliance of equity-based financing as applied by the Islamic banks in Malaysia. In addition, the study investigates the challenges in adopting equity-based financing in Islamic banks in Malaysia, and examines the current practice of *Mushārakah Mutanāqiṣah*, being one of the applications of equity-based contracts adopted by a few Islamic banks in the country.

The findings of the study are expected to shed light on the extent of involvement of the Islamic banks in Malaysia in equity-based financing. Several recommendations on possible ways to shift from debt-based financing to equity-based financing in the Islamic banks are highlighted such as the needed financial infrastructure to support adoption of equity-based financing by the Islamic banks.

2. BACKGROUND OF THE STUDY

2.1 EQUITY-BASED FINANCING: CONCEPTS, APPLICATIONS AND ISSUES

Conceptually, a fundamental departure of Islamic finance from conventional finance is the importance of profit and loss sharing contract being applied in Islamic financial transactions. In view of the investor-investee relationship, profit to investor is justified based on risk assumption, while that to the investee is justified based on the efforts. In contrast, conventional finance applied the concept of money lending where a pre-determined rate of interest is charged on the borrower for the money lent out by the bank. In a money-lending business, collateral plays a highly critical role in mitigating the risk of default.

The benefits of adopting the equity-based financing in Islamic finance are far-reaching. Askari et al. (2009) highlight the ability of Islamic finance to promote the concept of risk sharing as opposed to risk shifting or risk transferring in conventional finance.

The concept of risk sharing upheld by Islamic finance would be an effective mechanism for promoting financial stability as risks are being shared and distributed within the financial system. A system based on risk sharing, equity financing, and genuine asset securitization would link the payoffs of the financial securities to the underlying assets being financed. In this regard, Khan and Mirakhor (1987) conclude that Islamic banking provides a better alternative compared to the conventional system due to the potential robustness and stability that the system may provide.

Several studies (see, for example, Ahmed, 2001; Dusuki, 2008; Rosly and Bakar, 2003; Siddiqi, 1985; Siddiqui, 2002) regard profit and loss sharing as the only principle that represents the essence of the Islamic banking system. While these studies do not counteract the use of *Sharīʿah* permissible debt-based contracts alongside the equity-based contracts, they however, emphasize the socio-economic objectives that Islamic economics seeks to achieve. Therefore, they conclude that Islamic banks should not only be profit-oriented, but should also be promoting Islamic values and norms as a whole without undermining commercial viability.

Despite the fundamental differences between the Islamic and conventional finance, and the numerous benefits of Islamic finance to the overall financial system, there is increasing evidence suggesting that the Islamic banks tend to favor debt-based instruments rather than equity-based instruments. Lewis and Algoud (2001) document the very small share of the Islamic banks assets in the form of *Muḍārabah* and *Mushārakah*, with a prominent share of the assets in the form of debt-based instruments. Similarly, Khan (2004) highlights that only a small portion of Islamic bank assets (around 5%) consists of financing based on a genuine profit and loss sharing arrangement, while the remaining are mainly dominated by the debt-based mode of financing, particularly the *Murābaḥah* contract. Current Islamic banking practice has also supported the view that Islamic financial institutions are in favor of debt-based instruments. For example Asutay (2007) and Dusuki (2007) noted that the current practice of the Islamic banks worldwide show the majority of their financing operations have favored debt rather than equity. Consequently, this has created the suspicions among the sceptics and other critical outsiders who observed that Islamic banking and finance does not differ from conventional finance.

Mohd. Ariffin et al. (2009) find that the Islamic bankers perceived that the risks in equity-based instruments, namely *Muḍārabah* and *Mushārakah* are generally higher compared to debt-based financing (*Istiṣnāʿ*, *Murābaḥah* and *Ijārah*). Investments made via *Muḍārabah* and *Mushārakah* contracts may contribute substantially to Islamic banks' earnings, but the risk-sharing contracts expose them to significant rate of return risk. The study relies on survey questionnaire based on a sample of 28 Islamic banks in 14 countries.

From the regulators' perspective, the central bank of Malaysia, Bank Negara Malaysia (BNM), has also noted the inclinations of the Islamic banks in Malaysia toward debt-based financing (Ibrahim, 2010). Since adoption of equity-based financing has significant implications on Islamic bank risk management, it is suggested that Islamic banks adopt a gradual approach in applying the equity-based financing in their business model.

Several studies highlighted that the almost exclusive reliance on debt-based financing is one of the serious problems facing the Islamic banking industry (Ahmed, 2010; Beck et al., 2012; Siddiqi, 1985). Among others, many Islamic banks rely on interest rate as a benchmark in deciding the profit rate. Additionally, the heavy reliance on debt-based financing is also not advisable as it can lead to issues in getting the instalment paid on time to Islamic banks, which later lead to charging of penalty for late payment.

Ahmed (2010) and Wilson (1993) believed that equity financing is the way forward as it can be practised in a very moral manner. The principle of risk sharing and cooperation through participation is certainly preferable to the conflict of interest that often exists between borrower and lender in a debt-financing situation. Promulgating the ideals of equity-based financing method potentially results in outcomes that are in line with the objectives of an Islamic economy.

The benefits of equity-based financing outweigh those of debt-based financing in almost every aspect. From the economic point of view, an equity-driven economy promotes job creation as the skilled and unskilled labors would be able to offer their labor services to those with capital and would like to start a business venture. This is contrary to the case of the debt-based financing in which those who are willing to provide labor services but deemed as not creditworthy are unable to embark on providing their labor services. As the equity-based financing does not require collateral, the laborers who are motivated to supply their labor can readily enter the market without having to worry about providing collateral to the fund provider. Adopting the equity-based financing would also result in further improvement in the quality of labor. Laborers would want to further improve their skill according to the market demand as the contribution of capital would also depend, among others, the level of skill of the labor. More job creation in new economic ventures reduces unemployment, as workers would want to be up-dated with the current demand of employment in the job market.

Promoting equity financing would also promote innovation, entrepreneurship, and creativity. The *muḍārib* would continue to improve his skill and talent to attract more capital providers for a joint venture; the quality of the workers would increase as the economy further develops. On the capital provider side, there would be more concern about survival of a business venture, thus would together be contributing in terms of innovations and creativity on ways to exceed the competition. As equity financing involves mutual risk sharing pertaining to the enterprise and an equitable distribution of return, all this results in improved product and service quality for consumers. Improvement in the skill of the labor and promotion of productivity and creativity would provide a catalyst for more economic activity. Productivity results in better pricing, thus cheaper output. This would increase the demand for the country's output, locally and globally. As demand for the country's output increase, the circular flow of funds enables more economic activity and benefits all economic agents.

An equity-based driven economy entails greater economic activities as it involves direct participation of the owner of capital in the production process. Economic agents are concerned about the results of the business venture as the shared risk means that investors would have to bear the risk of business failure. Consequently, the system inculcates good values in business management practices to ensure the success of business ventures. As equity-based financing somehow entails active participation from the capital provider in terms of overseeing the business this improves transparency and reduces moral hazard issue that has been the major drawback of debt-based financing.

Equity-based financing is also justified and favored from the *Sharīʿah* perspective in the sense that it promotes achievement of *Maqāṣid al-Sharīʿah* or the higher purpose or objective of *Sharīʿah*. *Maqāṣid al-Sharīʿah* as defined by Ibn ʿĀshūr means "the deeper meanings and inner aspects of wisdom (*ḥikam*) considered by the Lawgiver in all or most [of] the areas and circumstances of legislation." In relation to wealth and financial management, it is the ultimate objective of the *Sharīʿah* to protect wealth with proper management and distribution. Thus, all the rulings of *Sharīʿah* relating to various types of financial transactions seek to protect the property and to ensure justice among the parties involved.

Debt-based financing based on sale or *Ijārah* contracts though *Sharīʿah* compliant, as claimed by some scholars, is not in line with *Maqāṣid al-Sharīʿah*. This is because of the element of debt, whereby the customer needs to pay more than the financing amount within stipulated period, regardless of the outcome of any economic activities. On the other hand, in equity-based financing, the financier and the customer would share the real outcome of a profitable economic activity. Therefore, equity-based financing promotes real economic activities and fair distribution of property, which is in turn closer to achieving the objective of *Sharīʿah* in wealth management.

Currently, few Islamic banks in Malaysia have been offering *Mushārakah Mutanāqiṣah* (MM), which is a form of equity-based financing to replace *Baiʿ Bithaman Ajil* (BBA) for home financing. This seemed to be a good starting point to encourage the use of equity-based financing in Islamic banks. MM is introduced to inspire the element of sharing in terms of capital and liability between financier and customer. Meera and Abdul Razak (2009, 2005) pointed out that the MM which consists of *Mushārakah* (partnership) and *Ijārah* (lease) contracts is a better alternative to the BBA in various aspects. It is purely based on rental payments of property and the redeeming of the financier's shares. The MM is based on a diminishing partnership concept, comprising of two components. First, the customer and the bank or financier enters a partnership under the concept of *Shirkah al-milk* (joint ownership). Then, the customer will redeem the bank's share gradually in predetermined time (at the beginning of an agreement) until the customer fully owns the asset such as a house. Second, in the procedure of redeeming the bank's share, the bank leases the ownership of the house to the customer under the concept of *Ijārah* by charging a rent. At the same time, the customer will pay periodic rentals to the bank for using the bank's share of the asset. Consequently, the customer's share ratio would increase after each rental payment until the asset is eventually fully owned by the customer.

The contract of MM is widely practiced in the Middle East, United States, Canada, United Kingdom and Australia. Bendjilali and Khan (1995) and Usmani (2002) agreed that the product could help people to rely less on BBA. Moreover, the MM can be implemented for housing financing and machinery financing whereby the assets can be leased out according to agreed rental payments (Usmani, 2002).

2.2 FINANCING MODES BY ISLAMIC BANKS IN MALAYSIA: DEBT VERSUS EQUITY-BASED FINANCING

Specific debt-based financing contracts frequently adopted by the Islamic banks include *Murābaḥah, Ijārah, Istiṣnāʿ* and numerous variations based on these contracts. Application of equity-based financing is seen to be less developed and adopted, where they may not function in a manner that could reveal their full potential. Based on the analysis of annual reports of sixteen Islamic banks in Malaysia and six Islamic banks in Bahrain, the following analysis can be made. Islamic banks continue to use debt-financing tools widely and have not so far been successful in implementing equity modes in a significant manner.

In the case of Malaysia, the analysis of fifteen Islamic banks reveals that for the years 2011 and 2010, only seven Islamic banks have equity-based financing in the forms of *Muḍārabah* and *Mushārakah*. For 2011, on average 91.5% of the total financing of the Malaysian Islamic banks are based on debt and only 8.5% of the total financing are based on equity. Similar results were also found in the 2010 where 93.9% and 6.1% of the total financing are based on debt and equity, respectively. Of the total debt-based financing, *Murābaḥah* and *Ijārah* financing dominated. This shows that despite the existence of Islamic banking in Malaysia for more than 25 years, the use of equity-based financing is still at very minimum level.

For the Islamic banks in Bahrain, the analysis of five Islamic banks arrives at similar findings. On average for 2011, 89.4% of the financing operations of the Islamic banks in Bahrain are based on debt, while only 10.6% of the financing are based on equity. Similarly, in 2010, while 90.7% of total financing of the Islamic banks in Bahrain are debt-based, a mere 9.3% are equity-based financing.

3. RESEARCH METHODOLOGY

This section explains the methodology and design adopted for this research, which comprises the analysis of both secondary and primary data.

This study covers all the sixteen Islamic commercial banks in Malaysia. The list of the banks involved in this study is provided in Table 1. The step involved the analysis of the bank's annual reports in order to understand the current practices on equity-based financing. This is followed by designing of an appropriate research instrument for data collection.

TABLE 1
List of Islamic Banks in Malaysia (as at end of 2014)

No	Name	Ownership
1	Affin Islamic Bank Berhad	Local
2	AmIslamic Bank Berhad	Local
3	Bank Islam Malaysia Berhad	Local
4	Bank Muamalat Malaysia Berhad	Local
5	CIMB Islamic Bank Berhad	Local
6	Hong Leong Islamic Bank Berhad	Local
7	Public Islamic Bank Berhad	Local
8	Maybank Islamic Berhad	Local
9	RHB Islamic Bank Berhad	Local
10	Alliance Islamic Bank Berhad	Local
11	HSBC Amanah Raya Berhad	Foreign
12	OCBC Al-Amin Bank Berhad	Foreign
13	Kuwait Finance House (Malaysia) Berhad	Foreign
14	Al Rajhi Banking and Investment Corp (M'sia) Berhad	Foreign
15	Asian Finance Bank Berhad	Foreign
16	Standard Charted Saadiq Berhad	Foreign

Source: Central Bank of Malaysia website

According to Sekaran (2003), the selection of the type of research design instruments depend on the kind of information needed to solve the research problems. This includes self-administered survey questionnaires, sent by mail or online. This study adopted self-administered questionnaire design as the most appropriate instrument. The questionnaires are developed from the theories and literature. The respondents were requested to respond on issues pertaining to the concepts of debt and equity financing, pricing and *Sharīʿah* compliance. Closed-ended type of questions using a scale of choices were used as it helps the respondents to make quick and objective decisions by selecting choices among several alternatives provided. The questionnaire was designed based on the widely used Likert scale which requires the respondents to indicate degree of agreement or disagreement with a series of statements. A four-point Likert scale was used to identify the responses to the research questions.

4. FINDINGS AND DISCUSSIONS

4.1 SAMPLE

Survey questionnaires were distributed to sixteen Islamic banks in Malaysia with five respondents in each Islamic bank, making a total of 80 respondents involved in this study. The five respondents in each bank were selected based on their various capacities in offering home financing products, namely from the *Sharīʿah* Committee, Legal, Products, Risk and *Sharīʿah* divisions (Abdul Razak, 2010). Of the total 16 Islamic banks, one bank refused to participate, resulting in 75 questionnaires being distributed to 15 Islamic banks[1]. Of the 75 questionnaires distributed, 39 were returned, resulting in a response rate of 52%.

TABLE 2
Sample Characteristics

Variable	Frequency	%
Gender		
Male	33	85
Female	6	15
Age(years old)		
25-34	11	27
35-44	18	48
45-54	7	19
55-64	2	4
More than 64	1	2
Education		
High School	1	3
Bachelor	12	31
Master	14	36
PhD	3	6
Professional Qualifications	9	24
Working Experience (years)		
0-5	5	12
6-10	7	18
11-15	12	32
16-20	6	16
More than 20	9	22

Table 2 summarises the demographic information on the respondents. Overall, 85% of the respondents were male, while 15% were female. The age grouping also indicates that the majority of respondents were above 35 years old with 48% in the 35-44 age group and 19% in the 45-54 age group. In terms of highest academic qualification, 31% of the respondents hold a Bachelor's degree, 36% have a Master's degree and 6% hold a PhD degree. Meanwhile, 24% of the respondents have professional qualifications. In terms of working experience, most respondents have more than ten years of working experience, indicating that they have sufficient experience to answer the questions.

4.1.1 RELIABILITY ANALYSIS

Reliability tests are conducted to determine consistency of the scale measurement. A reliable scale is one which could yield much of the same results on two different occasions (De Vaus, 2002). According to Oppenheim (2001), reliability may be measured in several different ways:

i) By repeatedly administering the scale to the same people within a short period (*test-retest* reliability). Time and budget constraints precluded application of this method in this study.

ii) Internal consistency method, which is an indicator of how well several different items measure the same variable. Iinternal reliability can be assessed through a number of methods in SPSS software. The most common method is Cronbach's alpha, where the average of all possible split-half reliability coefficients is calculated. Cronbach's alpha ranges in value from 0 to 1 because it can be interpreted as a correlation coefficient; the higher the value of alpha, the more reliable the scale. As a rule of thumb, alpha should be at least 0.70.[2]

For the present study, Cronbach's alpha is calculated for the overall measurements in order to measure the internal consistency of the scale. The Cronbach alpha for the items is 0.715(> 0.70). This means that each scale in the questionnaire measures a single concept and the items that make up the scale are internally consistent. In other words, the scale measurement of this questionnaire is internally reliable.

4.2 PERCEPTION OF BANKERS FOR THE USE OF EQUITY-BASED FINANCING IN ISLAMIC BANKS IN MALAYSIA: CONCEPT, PRICING AND *SHARĪʿAH* COMPLIANCE ISSUES

In an attempt to understand the general perception of bankers in the Islamic banks toward equity-based financing, the respondents were asked to indicate their level of agreement with the issues on concept, pricing and *Sharīʿah* compliance for equity-based financing in Islamic banks in Malaysia. The selection of the three measurements is in line with Abdul Razak and Ismail (2011). The mean value for each of the statements represents the degree of respondents' agreement on each statement. The results are shown in Tables 3 to 5.

TABLE 3
Concepts

No.	Statement	N	Mean
1.	Islamic banking is introduced because Muslims are prohibited from associating themselves with the element of interest as practiced by conventional banking.	39	3.65
2.	The profit and loss sharing principle in equity-based financing is the only principle representing a true spirit of Islamic banking system.	39	2.05
3.	Equity-based financing is profit sharing between the bank and the customer.	39	2.92
4.	Equity-based financing requires participation of banks to share risk-return in a particular business venture.	39	3.38
5.	Adopting equity-based financing means the banks are exposed to greater risk compared to adopting debt-based financing.	38	3.21
6.	The equity-based financing concept in *Mushārakah Mutanāqiṣah* is not similar to conventional home financing.	37	3.41
7.	The debt-based financing concept used in *Baiʿ Bithaman Ajil* financing is similar to conventional home financing.	39	1.95
8.	*Riba* (usury) does not exist in *Mushārakah Mutanāqiṣah* home financing.	39	3.67

Note: A 4-point Likert scale is used in the survey with 1 indicating Strongly Disagree, 2 Disagree, 3Agree and 4 Strongly Agree. Figures reported are the mean of each statement.

The findings in Table 3 suggest that the concept of equity-based financing is unique to Islamic banks due to the high mean responses. In particular, the respondents highly agreed that the equity-based financing concept in *Mushārakah Mutanāqiṣah* is dissimilar to conventional home financing. The respondents, however, did not seem to agree that the profit and loss sharing principle in equity-based financing is the only principle representing the true spirit of Islamic banking. Also, the respondents seemed to disagree on the statement that the debt-based financing concept in BBA financing is similar to conventional home financing. This is evidenced from the lower mean values for these two statements as perceived by the respondents (2.05 and 1.95, respectively) where it appears that the respondents seem to believe that the BBA can also represent the true spirit of Islamic banking system.

In addition, the respondents also do not agree with the statement that "Equity-based financing is profit sharing between the bank a bank and the customer". This may be due to the current practice of the Islamic banks that do not really adopt a true equity-based financing, which leading to there is no sharing of profits between the bank and the customer.

With reference to Table 4, the findings show that the respondents agree that if the pricing of equity-based financing is transparent, it will be fairer to both the bank and the customer. In addition, the respondents also agreed that if pricing in equity-based financing is more competitive, it is more attractive to the customer. These findings are generally predictable since customers always favor fairly priced or relatively cheaper products in the market. Nevertheless, there is a slightly more negative response toward the use of rental rate for pricing MM. The respondents did not agree that the price using rental rate in *Mushārakah Mutanāqiṣah* should be lower that the use of interest rate. This is because currently, in MM, the Islamic banks do not rely on rental rate as the pricing benchmark but rather on the interest rate. The responses seemed to indicate that the impact of pricing based on the rental rate is yet to be known.

Despite the common belief that equity-based financing is the ideal financing to be used by Islamic banks (Siddiqi, 1985), there are concerns on the implications of the *Sharīʿah* on the use of equity-based financing, particularly MM. Hence, as presented in Table 5, the survey discerns the respondents' opinion on the *Sharīʿah* issues on equity-based financing. In general, the respondents agree that MM home financing is *Sharīʿah* compliant because of the actual purchase of property by the bank and that it takes ownership risk, rendering the contract to be based on justice and equity. The respondents also seemed to agree that MM home financing reflects the true spirit of Islam in promoting societal well-being (*Maṣlaḥah*).This finding is in line with Abdul Razak et al. (2012) which indicated that MM home financing is perceived as just and equitable.

TABLE 4
Pricing

No.	Statement	N	Mean
1.	If pricing in equity-based financing is more competitive, equity-based financing is more attractive to the customer.	38	3.42
2.	If pricing of equity-based financing is transparent, it is fairer to both the bank and the customer.	39	3.44
3.	The method of computing profit in *Mushārakah Mutanāqiṣah* is not similar to the one in conventional home financing.	39	3.00
4.	The pricing of *Mushārakah Mutanāqiṣah* home financing is not similar to pricing in conventional home financing as rental rates replace interest rates.	38	2.79
5.	The pricing of *Mushārakah Mutanāqiṣah* home financing is fair because it is based on rental value of property.	38	2.82
6.	The price using rental rate in *Mushārakah Mutanāqiṣah* is lower than interest rate.	36	2.22

Note. The number of respondents for each statement varies since some insisted not to answer the questions.

From the mean statistics shown in Table 5, it is interesting to note that the respondents do not agree on selected *Sharīʿah* issues on equity-based financing. This is reflected by the low mean on the following issues: (a) the bank takes liability on the defects of the house in MM; (b) the bank requires a security from the customer under MM financing; (c) in the event of default, the bank can sell the asset without the consent of the customer; (d) MM home financing does not cause hardship and harm to individuals; (e) the bank can easily assist the customer during the financial difficulties under MM financing; and (f) MM home financing contributes positively to the equitable distribution of wealth and income. Out of nine statements on *Sharīʿah* compliance issues, only three scored a mean more than three points. While an ideal MM contract would require the Islamic banks to offer MM home financing with the stated characteristics in order to be compliant with the *Sharīʿah*, it is clear that the respondents could be responding to these questions based on technicality of the MM home financing. This indicates that the actual application of the MM contract in the context of banking environment in Malaysia seems not to be in line with the objectives of *Sharīʿah*. These findings indicate that the practice of MM home financing does not fulfil the objectives of *Sharīʿah* based on the perceptions of the respondents.

TABLE 5
Sharīʿah Compliance

No.	Statement	N	Mean
1.	*Mushārakah Mutanāqiṣah* home financing is *Sharīʿah* compliant because there is real purchase of property and bank takes ownership risk.	37	3.00
2.	The bank takes liability for the house defects in *MushārakahMutanāqiṣah* financing.	37	2.49
3.	The bank requires a security from the customer under *Mushārakah Mutanāqiṣah* financing.	37	2.86
4.	In the event of default, the bank can sell the asset without the consent of the customer.	37	2.22
5.	*MushārakahMutanāqiṣah* home financing is based on justice and equity.	37	3.14
6.	*Mushārakah Mutanāqiṣah* home financing does not cause hardship and harm to individuals.	36	2.81
7.	The bank can easily assist the customer during financial difficulties under *Mushārakah Mutanāqiṣah* financing	37	2.72
8.	*Mushārakah Mutanāqiṣah* home financing reflects the true spirit of Islam in promoting the well-being of society (*Maslahah*).	37	3.05
9.	*Mushārakah Mutanāqiṣah* home financing contributes positively to the equitable distribution of wealth and income.	37	2.95

5. CHALLENGES OF EQUITY-BASED FINANCING IN ISLAMIC BANKS IN MALAYSIA

Next, the respondents were asked to identify the top five challenges in implementing equity-based financing from a list of possible challenges provided in the questionnaire. The possible challenges were obtained from previous studies (Khan and Ahmed, 2001; Lewis and Algoud, 2001; Khan, 2004; Mohd. Ariffin et al., 2009). Only 29 respondents answered this question and the findings show that the top five challenges based on the responses selected are as in Table 6.

TABLE 6
Top Five Challenges in Implementing Equity-based Financing

	Frequency	%
Difficult to implement in the existing system	21	72
High risk	19	66
Difficult to implement on projects under construction	19	66
Legal problems	18	62
Difficulties in documenting the product	11	38

Note: Out of 39 respondents being surveyed, only 29 answered this question and the percentage is based on the number of respondents selecting the challenges divided by 29 respondents.

Other challenges mentioned by the respondents in the open-ended section include:

i) Issue of shortfall after foreclosure of property: Banks are unwilling to share the loss if there is shortfall after the closure of property. Banks transfer the shortfall risk by asking customer to change into "purchase undertaking" under the contract of *Waʿad*/promise. This means that in the event of default, the customer must purchase the property at the exercise price equal to the selling price;

ii) National land code does not allow banks in Malaysia to have any relationship with the developer;

iii) Equity-based financing cannot depart from debt-based financing;

iv) The mentality toward debt-based financing is difficult to change;

v) Lack of expertise on how it is done and how it is supposed to work, for examples, preparation of legal documents, monitoring of *Ijārah* rental rate, updating customer on share ownership.

From all these challenges as perceived by the respondents in the survey, the findings show that Islamic banks need more efforts to promote equity-based financing, particularly MM home financing. The Islamic banks must be willing to undertake a thorough and comprehensive study before embarking on offering this product so that they will be able to offer the true equity-based financing and not just mimicking the conventional loans or just changing the name of the existing product to increase the equity-based portion in Islamic banks. This requires a dedicated team in the Islamic banks to undertake the study. With the creation of *Sharīʿah* research function as required by the *Sharīʿah* Governance Framework issued by Bank Negara Malaysia to all Islamic banks in Malaysia, this function can perform this task.

6. CURRENT PRACTICE OF *MUSHĀRAKAH MUTANĀQIṢAH* BY SELECTED ISLAMIC BANKS IN MALAYSIA

Several Malaysian Islamic banks prefer MM financing over BBA, though the latter has predominantly been practiced by all Islamic banks in Malaysia for home financing. MM is a contract of partnership between two parties, where one partner gradually buys the whole of the property. Kuwait Finance House first offered MM in Malaysia in 2006 although this contract had existed since 1995. At present, home financing through MM has widely begun in Malaysia. As can be seen from Table 7, half of respondents denote that their banks have already implemented MM. In addition, the average period that the banks have implemented MM is one year and the findings show that one of the banks already implemented it for the past six years.

TABLE 7
Implementation of *Mushārakah Mutanāqiṣah* Financing by Islamic Banks

	N	%
Implemented	19	50
Not implemented	19	50
Total	38	100

Note. Out of 39 respondents being surveyed, only 38 answered this question**.**

The survey results show that 50% of respondents in this study are of the opinion that their Islamic banks already implemented MM despite all the challenges and problems from the *Sharīʿah* perspective with regard to the true MM in practice. Similar to Abdul Razak et al. (2012), the results from this study indicate that conceptually, MM home financing is perceived as just and equitable.

However, based on the specific dimensions of *Sharīʿah* compliance measurements, the majority of the respondents viewed that the MM home financing being practised by the Islamic banks do not fulfil the objectives of *Sharīʿah*.

7. CONCLUSION

With the aim of exploring the extent of practice in equity-based contract by the Islamic banks, the study finds that the Islamic banks are not actually utilizing profit and loss modes or equity-based financing in their portfolio to any meaningful extent. This is evidenced by the lower portion in the total financing under equity-based financing as compared to debt-based financing.

Based on the findings of this study, the respondents generally agree that the principle of profit and loss sharing element under equity-based financing represents the true spirit of Islamic banking practices. However, because of the complex nature of equity financing products compared to the conventional debt-based products, Islamic banks are hesitant to apply the true concept of equity financing contract because of various constraints. As such, the benefits of adopting the equity-based contract have yet to be evident. Despite this, conceptually, there is a high perception among the respondents that MM home financing has advantages compared to conventional home financing as it is more just and equitable. This study suggests that more research by Islamic banks be undertaken before offering new products to the customers and effective marketing and generating more awareness in customers about Islamic finance. This will increase the possibility to move closer to the true form of the Islamic banking paradigm. The regulators also need to understand the real nature of such practices by the Islamic banks and establish a uniform regulation for MM to provide a clear guideline for the Islamic banks to offer the true MM financing.

The study finds that most of Islamic banks in Malaysia still provide home financing through BBA contracts. It is hoped that more Islamic banks will adopt MM home financing to benefit their customers and to be more *Sharīʿah* compliant as well. However, some legal rules related to Islamic banking contracts, tax and land ownership need moidification before implementing MM. Besides, the *Sharīʿah* prescribed conditions must be observed in MM, otherwise it would merely be a disguised form of interest-based loan.

ENDNOTES

1. One bank refused to answer the questionnaire because the bank currently did not offer any equity-based financing. The bank argued that most of the questions posed are not relevant because it views both *Mushārakah Mutanāqiṣah* and BBA Home Financing being practiced today as similar, particularly in term of pricing and the achievement of the *Maqāṣid Sharīʿah*. According to this respondent, to categorize *Mushārakah Mutanāqiṣah* Home Financing as equity-based financing is misleading as there is no difference in its practice compared to debt-based financing based on *Baiʿ Bithaman Ajil* and *Ijārah*. As such, home financing in practice are all debt-based irrespective of the name used. The respondent has the view that in practice, equity financing is only used in Venture Capital and Private Equity financing, and not in banking products. The respondent also argued that the risk profile of a commercial bank does not allow the bank to offer equity financing. In view of this, the bank is excluded from the sample.
2. See De Vaus, 2002, pp 184.

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