



Issues and Challenges of the Application of *Mudarabah* and *Musharakah* in Islamic Bank Financing Products

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Abstract

There has been a record of limited Islamic financial institutions applying risk sharing principles in financing product, especially *Mudarabah* and *Musharakah*. The issues of high risk and multi-faceted business risks that are associated with *Mudarabah* and *Musharakah* become the main obstacle in the implementation. This study aims to explore the current development of *Mudarabah* and *Musharakah* contracts in Islamic financing products, to analyze the issues and challenges in the implementation of *Mudarabah* and *Musharakah* contracts in Islamic financing products from the perspective of Islamic banks, regulators, and customers/entrepreneurs. It also explores the possible recommendations to enhance the implementation of *Mudarabah* and *Musharakah* contracts in Islamic financing products. This study uses library research method by acquiring and analysing the information from literature related to the products and issues on *Musharakah* and *Mudarabah* as an equity mode of financing. This study finds that high risk, asymmetric information problems, moral hazard, and difficult financing evaluation processes are the main reasons of Islamic banks not offering financing product with profit and loss sharing contract. At the same time, regulators also require better risk mitigation for the scheme due to its high risk. To increase the development of *Mudarabah* and *Musharakah* products, the authors recommend the industry to change their mindset of Islamic banking operations, increase customer awareness, adopt fintech to reduce evaluation and monitoring costs, and improve the regulatory framework that supports Islamic banking by issuing regulations and incentives which could encourage the implementation of profit and loss sharing scheme.

Keywords: *Mudarabah*, *Musharakah*, profit and loss sharing, equity financing

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1. Introduction

Many contemporary Islamic economic scholars encourage the usage of profit and loss sharing (PLS) i.e. *Mudarabah* (profit sharing) and *Musharakah* (profit-loss sharing) instruments due to its absence of *riba* and *gharar* in conducting Islamic financial system to support the economy. However, in reality the PLS contract is less preferable by financial institutions because of various barriers such as legal requirements and moral hazard problems (Mazuin, 2016). Moreover, the customers are also not daring enough to bear the risk of this kind of financing. Therefore, they need to be more educated about the essentials of the partnership contract.

In the development of Islamic finance, it has been said about the limited record of Islamic financial institutions applying risk-sharing principles in the financing product, especially *Mudarabah* and *Musharakah*. The issues of high risk and multi-faceted business risks that are associated with *Mudarabah* and *Musharakah* become the main obstacle in the implementation. The profit-sharing contracts are typically applied in the “profit-sharing investment account” (PSIA) to mobilise the fund. In most Islamic banks, investment account contracts are structured using *Mudarabah* where the Islamic banks act as *mudarib* and share the profit with the profit-sharing investment account holders (PSIAH).

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On the other hand, there are limited records on the financing of products using *Mudarabah* and *Musharakah* financing due to the risk carried by these contracts. Although the presence of Investment Account Platform (IAP) initiated by the central bank of Malaysia (Bank Negara Malaysia - BNM) exists to promote risk-sharing, the bank's role is still the same as *mudarib* which mobilizes the fund from investors to the ventures through bank's financing facilities using exchange-based contract instead of equity-based contract.

Ashraf and Hussain (2011) noted the report of moral hazard of customer reporting losses in their financial statements to avoid paying the *rabb al mal* (bank), suggested that Islamic banks in *Mudarabah* and *Musharakah* arrangements may require customers to provide their integrity to protect the bank. All this highlights the need to analyze the issues and challenges facing *Mudarabah* and *Musharakah* financing. In addition, the comprehensive views from the practitioners, scholars, and customer are needed to strengthen this practice and to understand the challenges to promote these concepts.

The paper aims to achieve three objectives. First is to study the current development of *Mudarabah* and *Musharakah* contracts in Islamic financing products. Second, is to analyze the issues and challenges in the implementation of *Mudarabah* and *Musharakah* contracts in Islamic financing products from the perspective of Islamic banks, regulators and customers. Lastly, to explore possible recommendations to enhance the implementation of *Mudarabah* and *Musharakah* contracts in Islamic financing products. The results of the research should encourage Islamic banks to be more innovative in offering a PLS financing scheme, inspire regulators to enhance their existing regulatory framework, and increase entrepreneur's awareness and knowledge that can encourage them to request a PLS sharing financing scheme from Islamic banks.

This study uses a qualitative method to collect and analyze data and information. In collecting data, the study uses a library research method, a step-by-step process in acquiring and analyzing the existing data from various types of literature reviews regarding the products and the issues on *Musharakah* and *Mudharabah* as an equity mode of financing. To gain more issues and challenges, the researchers look into *Musharakah* and *Mudarabah* financing practices by Islamic banks in two countries, i.e. Malaysia and Indonesia.

2. Literature Review

2.1. Mudarabah and Musharakah in Classical Perspective

Based on etymological perspective from Arabic language, *Mudarabah* is derived from the term *dharb* which has several meanings. The different meanings are determined by the word and the context used. However, it can be concluded if *dharb* means the movement of a matter to the another one (Muhammad, 2005). *Mudarabah* contract is also known as *qirad* in the text of Islamic law. The term could have also been derived from the term *muqaradah* which indicates equality due to their fair way in distributing profit based on their respective contribution (Sadique, 2009).

It is stated in *Lisan al-'Arab* by Ibn Manzur (2006) that *Mudarabah* is an arrangement between two parties which one party gives the capital and the other one receives it for involvement in trade. Both of the parties have a deal through a mutual agreement that the profit is to be shared between them or that the latter is entitled to a defined share of the profit (Sadique, 2009). Hanbali jurists have broadened the meaning of *Mudarabah* by providing two instances. First, although the capital is invested by one party, the labour is provided by both parties who share the profit among them. The other one is where both parties provide capital while labour is undertaken by one of them (Ibn Qudamah, as cited in Sadique, 2009).

Meanwhile, *Musharakah* is derived from the Arabic word *sharaka* which means sharing and mixing shares of two or more parties to make them interchangeable (ISRA, 2016). As one of the essential contracts in Islamic finance, the term *Musharakah* is actually not being used to indicate partnership in traditional Islamic literature, although it is linguistically correct in derivation (Sadique, 2009). The Shafi'i scholars define *Musharakah* as 'a confirmation of the rights of two or more people over a common property' (al-Sharbini as cited in ISRA, 2016). The Hanafi scholars define *Musharakah* as 'a contract between partners on both capital and profit'. Meanwhile, the Maliki scholars define the contract as permission to transact where each of the partners consents the other to do a transaction with the partnership property while at the same time retaining his own right to transact with the same property (Al-Dardir, n.d.). In the Qur'an, Allah SWT mentions about *shirkah* which concerns in joint ownership of inheritance (Surah An-Nisa verse 12). However, *Musharakah* or *shirkah* has legality based on the consensus among Muslim scholars.

2.2. *Mudarabah and Musharakah in Contemporary Islamic Scholar Perspective*

In general, many contemporary Islamic economic scholars encourage the usage of PLS i.e. *Mudarabah* (profit sharing) and *Musharakah* (profit-loss sharing) to support the economy despite the PLS contract being less preferable due to legal requirements and moral hazard problems (Mazuin, 2016).

Aforementioned that in the classical perspective, *Mudarabah* consists of one *rabb al mal* (investor) and one *mudarib* (entrepreneur). However, according to Maliki scholars, there is no restriction on the number of investors or entrepreneurs in the same contract with the permission of the capital provider. In the case of several entrepreneurs, al Sarakhsi, one of Hanafi jurists stated they could only act in accordance with mutual agreement and approval of the investor. If *mudarib* acts without the permission of the investor, he becomes liable to bear any losses due to the independent and the unauthorised action (Borhan, 2004).

In this modern era, many Islamic financial contracts have been developed, including the PLS contract. According to Al-Zuhayli (2007) as cited in Mazuin (2016), currently there are some contracts that use the *Mudarabah* (profit sharing) concept, i.e. simple partnership (*sharikat al-tawsiyah al-basitah*), particular partnership (*sharikat muhassah*), joint stock companies (*sharikat musahamah*) and hybrid limited partnership (*sharikat al-tawsiyah bi-l-ashum*). A two-tier *Mudarabah* contract is introduced in the current period as a basis of *mudarabah* contract conducted by Islamic financial institutions (IFIs). In a single-tier contract, the fund provider deals directly with the entrepreneur, while in two-tier contracts, the fund provider entrusts their funds to an agent (the IFI), who acts as an intermediary to deal with the chosen entrepreneurs to execute the projects.

Meanwhile, *Musharakah* is a term frequently referred to one of the Islamic contracts in the context of Islamic modes of financing. In fact, the connotation of this term is a little limited than the term *shirkah* which is more commonly used by classical Islamic scholars. According to Usmani (1998), in the contemporary era, the term *Musharakah* is normally restricted to *shirkah al-amwal*, where two or more parties invest some of their capital in a commercial joint venture. In terms of profit distribution, he argued the proportion of profit between the parties must be agreed upon at the time when the contract has been considered in effective. If the proportion has not been determined upfront, the contract is not valid in Shariah. The ratio of the profit for each of the cooperating parties must be determined in proportion to the actual profit accrued to the business. Thus it is not in proportion to their invested capital (Arshad and Ismail, 2010).

2.3 *Previous Studies on PLS Instruments in Islamic Financing Products*

There were previous studies which have identified the motive of the limited IFIs applying risk-sharing principles in financing product. Using the grounded theory, Sabrina and Abd Majid (2020) categorized the issues behind the low volume of PLS-based financing products in three points of view which are internal, external, and regulatory factors. From the internal aspects, there are several issues such as high risk, lack of quality and quantity of human resources, complicated handling, lack of banking product innovation, asymmetric information, and lack of socialization. Meanwhile, from the external aspects, the low volume of PLS-based financing is caused by moral hazard, lack of community's knowledge in Islamic banking products and low demand. From the aspect of the regulation, the low volume of loss and PLS-based financing products is caused by a lack of support from the regulator. Besides those factors, Abdul-Rahman and Nor (2016) added some other major obstacles to PLS financing such as difficulty in selecting appropriate partners, the demand for PLS financing products which comes from low credit worthiness customers, and lack of capital security.

Another group of studies has explored the issues regarding the application of *Mudarabah* and *Musharakah* in Islamic financing products qualitatively. By conducting literature work and interviews with 23 senior officials associated with the Islamic banking industry in Pakistan, Afzal and Hassan (2018) found that there is an inverse relationship between *Mudarabah* growth and operational difficulties which can be interpreted that as operational difficulties increased, managers of the Islamic banks will discourage customers from adopting *Mudarabah* financing as their first choice. Meanwhile, Islam and Ahmad (2020) looked into the possibility of introducing *Mudarabah* and *Musharakah* as the financing mechanism for underprivileged women entrepreneurs in the state of Selangor (Malaysia). The study found that the implementation of risk-sharing principles in the financing products would be viable if clients' knowledge of Shariah and PLS contracts were improved along with their religiosity and entrepreneurial skills. It is supported by the study conducted by Jais et al. (2019) that suggested Islamic banks to ensure whether their partners have the required entrepreneur skills and experience, especially in the practice of *Mudarabah*.

The previous studies show that the issues regarding the limited application of *Mudarabah* and *Musharakah* in IFIs financing products have risen for a long time without any significant improvements to increase the offering of PLS-based financing products. In response to previous studies, the present study intends to comprehensively analyze the issues and challenges of Islamic banks in offering PLS-based financing products. In analyzing the issues and challenges, this study will use the library research method to identify the viewpoint of three parties, i.e. the Islamic banks, the regulator and the entrepreneurs. From the regulatory perspective, the study observes and compares the *Mudarabah* and *Musharakah* guidelines and regulations issued by the regulator in Malaysia and Indonesia.

3. Research Methodology

This study mainly used literature review in completing the research. In collecting data, we used a library research method mainly to gather information regarding the concept of *Mudarabah* and *Musharakah*. Further, a step-by-step process is used to acquire and analyze information from various types of documents, i.e. articles from reputable journals, individual bank's public information, regulation and provisions to complement the discussion regarding the products and issues on *Musharakah* and *Mudarabah* as an equity mode of financing in Islamic Banks in Malaysia and Indonesia.

4. Discussion and Finding

4.1. Current Practices of Mudarabah and Musharakah Contracts in Islamic Financing Products

Mudarabah and *Musharakah* financings are equity-based financing models that represent pure Islamic banks structure and should be promoted as a priority. However, not many banks are set up to handle equity-based financing due to the risk it carries and the risk threshold a normal bank is willing to take. In fact, shareholders expect medium to high returns on their equity with the lowest risk and operating cost as possible. Therefore, the risk nature of equity-based financing and potential diminished equity does not bode with many banks.

According to the Islamic Financial Services Board (IFSB) key exhibits in Figure 1, Islamic banks still prefer exchange-based contracts rather than equity-based contracts in providing financing to customers. Only less than 5% of the financing by Islamic banks are using the equity-based contract. Islamic financing was dominated by *Tawarru'* and *Murabahah* contracts which cover more than 20% of the total Islamic financing across the globe. It shows that Islamic banks could not bear the risk of capital impairment, information asymmetry and limited possibilities of monitoring and controlling, which could lead to increase risks for the Islamic banks. The next section will discuss the current application of *Mudarabah* and *Musharakah* financing in several Islamic banks.

4.1.1. Mudarabah Financing

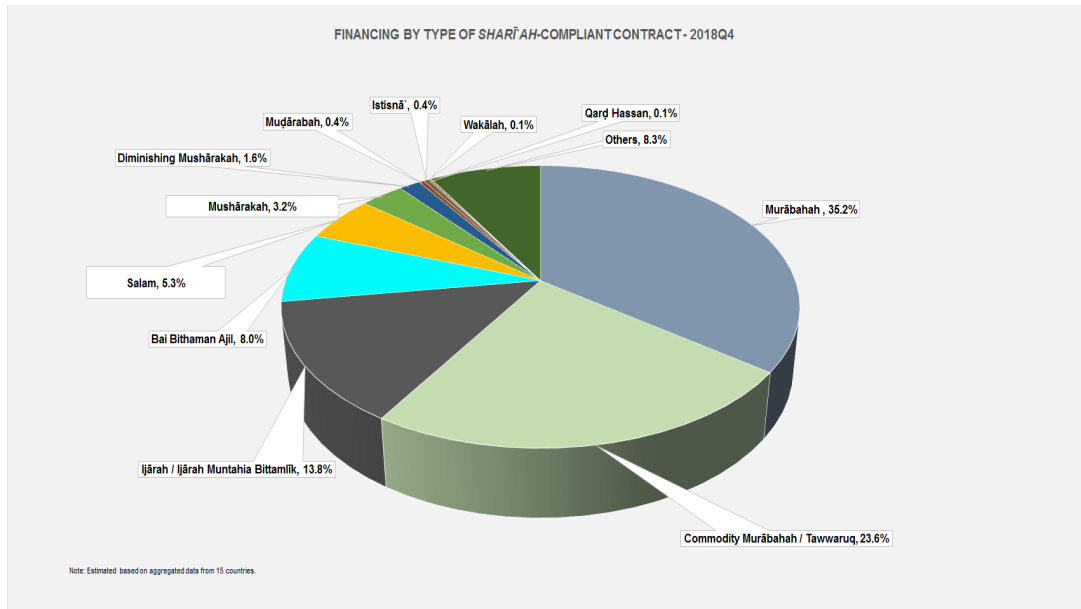
According to Yusof (2017), there are not many products available in the Islamic financial market that are structured as pure *Mudarabah*. Banks are not willing to provide such financing structures where the capital is at risk. Usually, *Mudarabah* is used as a deposit structure. To cater to this challenge, BNM initiated to develop a product via a stand-alone platform, where the bank's involvements are minimum and the platform acts as a direct link between investors (with equity fund) and business (entrepreneurs) as partners. This platform is called the Investment Account Platform (IAP) which was launched in 2015. Currently, the ventures listed in IAP use *Musharakah* Restricted Investment or *Mudarabah* Restricted Investment Accounts (RA).

The intention of IAP is to link the retail/corporate investors directly with companies seeking funding for their businesses. IAP also represents the contractual relationship between the investors and the Islamic Banks. In this scheme, the investor can specify where funds are channelled to (i.e. choice of underlying ventures to invest in) and define investment mandate and eligibility criteria for the financing (e.g. investment tenure and types of industry) to Islamic banks. Any returns on IAP are based on the performance of underlying ventures. Since it is a PLS scheme, funds placed under IAP are not guaranteed by the deposit insurance corporation. The transaction of IAP is illustrated in Figure 2.

The application of *Mudarabah* and *Musharakah* financing through IAP is varied among the Islamic banks. For instance, Bank Islam Malaysia Berhad (BIMB) with "Restricted Investment Account via IAP" product (Figure 3). BIMB and the investor sign a *Wakalah* contract as the bank will act as an agent of the investor. The bank disburses the financing facility to the venture which is mostly under Islamic exchange

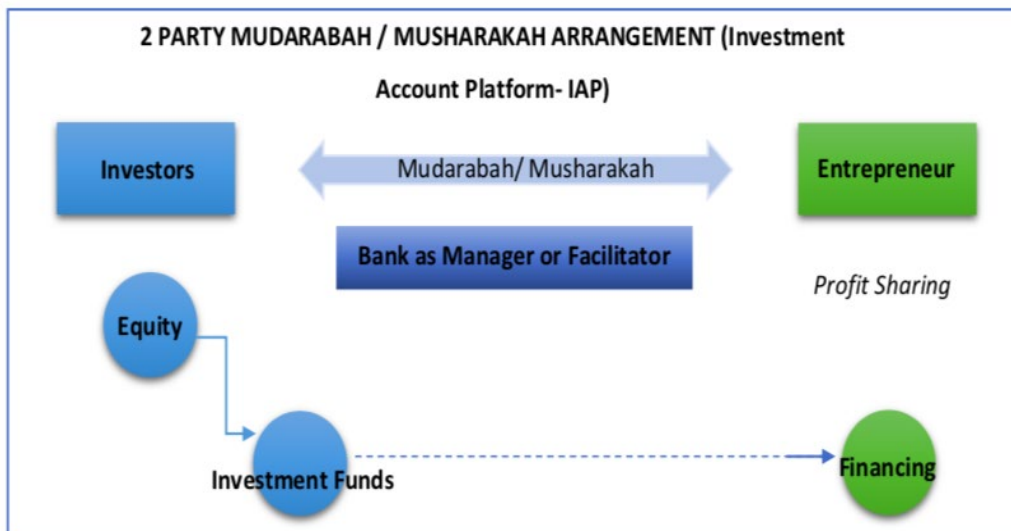
contracts. The venture will pay the instalment, and then BIMB will distribute the profit and principal based on *Wakalah* contract. If the venture is unable to pay for the instalment, no distribution of profit will be made to investors due to no profit to be declared; hence, any loss will be borne by the investors.

Figure 1: Financing by Type of Shariah-Compliant Contract



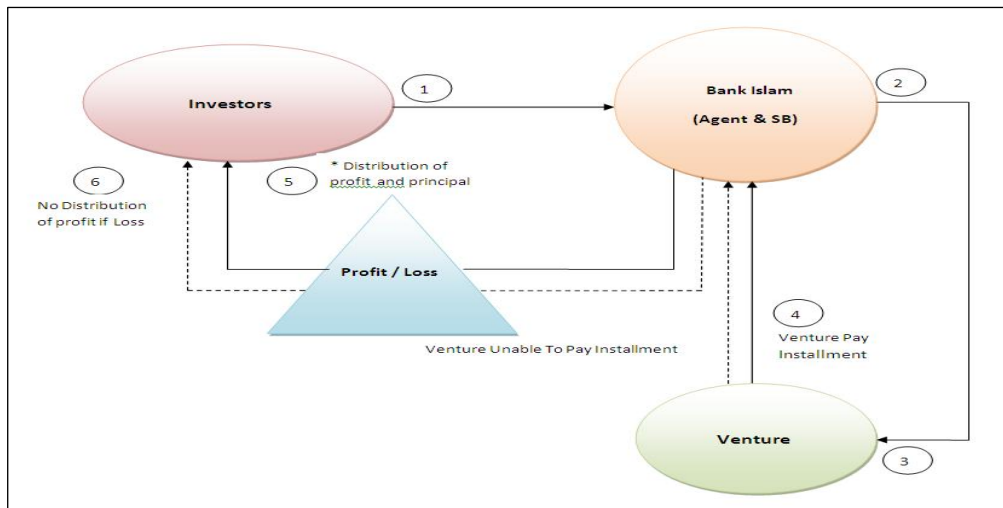
Source: (IFSB, 2019a)

Figure 2: Two-Party *Mudarabah/ Musharakah* Arrangement in Investment Account Platform (IAP)



Source: Islamicbankers.me (n.d.)

Figure 3: Mudarabah and Musharakah financing through IAP



Source: Islamicbankers.me (n.d.)

In Indonesia, Bank Mandiri Syariah (BSM) offers *Mudarabah* financing where BSM finances all the working capital needed (Bank Syariah Mandiri, n.d.). The profit is divided according to the ratio obtained. The facility obtained by the venture including profit is shared according to the agreement, flexible financial return mechanism (monthly or at the end of period), and profit-sharing based on revenue sharing calculation.

Another Islamic Bank in Indonesia that offers *Mudarabah* financing contract is Bank Syariah Bukopin (BSB). Using a *Mudarabah* contract, the bank and customer make an agreement, where the bank provides all capital and customers as managers with profit-sharing based on the agreed profit-sharing ratio. This product is intended for individual and business entities for a period of time according to the project completion. To mitigate the bank's risk, the venture has to provide collateral worth 125% of the financing amount (Bank Syariah Bukopin, n.d.-a)

These practices show that Islamic banks are less preferable in offering *Mudarabah* and *Musharakah* contract for their financing products because there are several additional risks that must be borne by the bank. Both Malaysian and Indonesian Islamic banks have tried to offer such financing schemes. However, there are some issues with their application. IAP in Malaysia is trying to facilitate investors and entrepreneur experiencing the risk-sharing concepts; however, the Islamic bank still uses exchange-based contracts in the financing distribution to the ventures. Meanwhile, several Islamic banks in Indonesia have offered these types of financing contracts, but the financing terms are mostly similar to exchange-based financing contracts, i.e. collateral requirements and predetermined instalment.

4.1.2. Musharakah Financing

As well as *Mudarabah*, Malaysia offers *Musharakah* financing through IAP. On this platform, investors assess a project and if the project matches their risk appetite, they will invest into the business. At the end of the period, the project will realize its profit and distribute accordingly based on the agreed profit-sharing ratio. If there are any losses, the capital will be diminished according to each partner's portion. *Musharakah* is also listed as an investment product. In this structure, the customer acts as an investor to invest the fund in economic activity. The bank will earn fees as a manager and earn a return on its own equity.

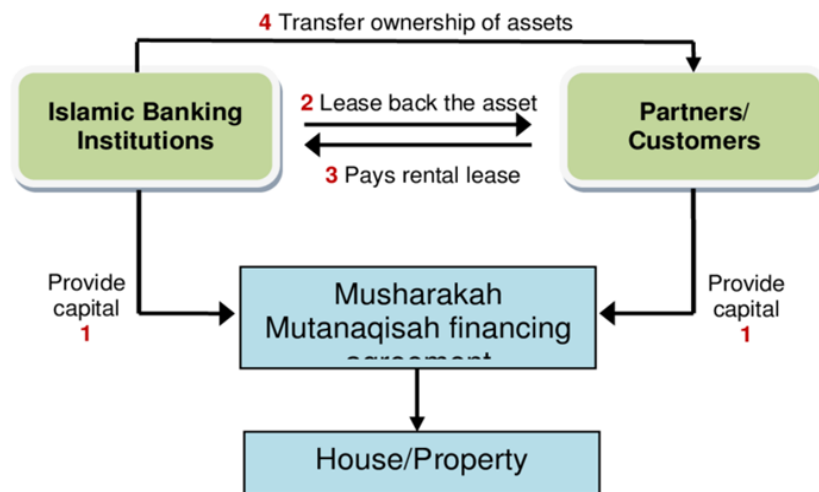
In Indonesia, Bank Syariah Bukopin offers the *Musharakah* financing (Bank Syariah Bukopin, n.d.-b). The contract used is *Musharakah*, which is a collaboration between the bank and the customer to mix their funds or capital in a particular business, with the distribution of profits based on the agreed profit-sharing ratio. This financing is intended for individual and business entities with self-financing at least 30% of the total capital. However, as well as *Mudarabah* financing, the bank also requires collateral worth 125% of the financing amount.

4.1.3. *Musharakah Mutanaqisah*

Due to some challenges on the *Musharakah* contract implementation, practitioners have improvised *Musharakah Mutanaqisah* (MM) as a more practical version of partnership. Currently, MM or Diminishing Partnership is applied in home financing by Islamic banks in Malaysia to replace the *Bai' Bithaman Ajil* (BBA) and *Bay al-Inah* contracts.

The MM contract uses the concept of *Musharakah* (partnership), *al Bay'* (sale), and *Ijarah* (lease). Initially, MM is proposed to introduce the Islamic bank market to the concept of equity financing. In general, MM consists of two agreements; first, a client enters into an agreement with the Islamic bank under the concept of joint ownership (*Shirkat-al-Milik*) where the client will then gradually buy back the bank's share at an agreed portion periodically until the property/asset is fully owned by the client. Second, the Islamic bank leases its share in the property ownership to the client under *Ijarah* contract; by charging rent. The client agrees to pay the rental to the bank for using its share of the property/asset until the bank's ownership portion diminishes. The MM scheme is illustrated in Figure 4.

Figure 4: *Musharakah Mutanaqisah* Structure



Source: Authors' Own

Islamic scholars agreed on the implementation process of *Musharakah Mutanaqisah*. Usmani (1998) agreed that the *Musharakah Mutanaqisah* could help people to rely less on other financing facilities which are debt-based contracts. This structure encourages people and Islamic financial players to use equity financing. According to Usmani, joint ownership of a house or asset is acceptable by all schools of Islamic *fiqh*.

Furthermore, the concept of *Musharakah Mutanaqisah* can also be applied for micro-financing (Saad and Razak, 2013). It could be applied to acquire other forms of assets such as buying a truck or van for earning income and using it as a hired vehicle. The profit gained from the business is then shared between both parties based on the capital contribution.

4.2. *Issues and Challenges in the Implementation of Mudarabah and Musharakah Contract in Islamic Banking Product*

Based on the above observations, equity-based financing is still less accepted and not well-offered by Islamic banks in many jurisdictions, including in Malaysia and Indonesia, even though it is very close to the objective of the establishment of Islamic banks. In Malaysia, the total amount of financing with *Musharakah* and *Mudarabah* contract is still very small compared to the overall financing practiced by Islamic banks with only 6 percent (BNM, as cited in Abdul-Rahman and Nor, 2016). This section will discuss several issues and challenges in implementing the *Mudarabah* and *Musharakah* contracts in Islamic bank financing products from the views of three parties, i.e. Islamic banks, regulators and entrepreneurs. From the regulatory perspective, the study observes and compares the *Mudarabah* and *Musharakah* guidelines and regulations issued by the regulator in Malaysia and Indonesia.

4.2.1. From an Islamic Bank Perspective

Aforesaid, the Islamic banks face huge issues and challenges in implementing *Mudarabah* and *Musharakah* contracts and most of them still prefer to offer exchange-based contracts, i.e. *Murabahah*, *Ijarah*. The subsection discusses several reasons underlining the circumstances.

4.2.1.1 High Risk

Banks prefer low-risk products; the lower the risk, the better. However, *Musharakah* and *Mudarabah* are classified as high-risk products by the banks. There are various types of risks that Islamic banks will face as a *rabbul mal* (capital provider) or *musharik* (partnership) (Shodiq, n.d.). However, the risks that can give so much impact to the Islamic bank to implement PLS in their financing are three risks; financial risk, business risk and rate of return risk.

The nature of *Mudarabah*, Islamic banks do not have any access or right to monitor the decision and management made by the *mudarib*, especially if there is any claim of losses. It will affect the liquidity of the bank directly as the finance provided by Islamic banks are mainly from depositors' deposit. On top of that, financial risk will eventually affect business risk as well. Business risk can be exposed when there is an insufficient fund to continue the operation of the project. Last but not least, the rate of return risk when there is uncertainty on the return of the bank because they only know the exact amount after the end of the period. Thus, it is very difficult and very risky for the Islamic bank to implement both financing products.

The concept of both *Musharakah* and *Mudarabah* is to share the profit and also the loss that occurs. Hence, Islamic banks are very cautious in providing finance because the fund is most likely from the depositors that deposit their money in the Islamic banks. They expect their deposit money to be in a safe hand. If anything happens in the future, Islamic banks need to bear the loss and replace depositor's money. Banks do not want to share the loss; they only want to share profit. In other words, they want anything that can minimize losses and maximize profits.

4.2.1.2. Asymmetric Information Problem and Moral Hazard

Most likely, in *Mudarabah*, the majority of *mudarib* will have enough and more information regarding the project whereas Islamic Banks do not have access to know its profitability. Hence, this will lead to a conflict between both parties (Sapuan, 2016). Islamic banks need to screen, monitor, and analyse comprehensively and be cautious to avoid any loss when conducting the project. Information from the first process until the end of the process must be disclosed and transparent to avoid any false information.

Asymmetric information can happen when the *mudarib* or *musharik* fails to report the outcome of the project accurately due to their untruthful and dishonest behaviour. For example, the partner declared that they are in the loss in order to avoid paying the agreed profit (Naim et al., 2016) and when the partner is no longer interested nor motivated to fulfil the project (Sapuan, 2016). If these happen, banks will not make a profit due to *musharik* or *mudarib* untruthful behaviour. Banks are not ready to bear this kind of losses.

4.2.1.3. Financing Evaluation Process

The financing selection process can be one of the big challenges for Islamic banks to provide their financing. They need to find the right partner to conduct the business specifically to sustain their competitiveness and at the same time to gain profit. Besides, conducting a close monitor of the *mudarib* performance will include more costs for the Islamic banks. Hence, they need to ensure and properly take into consideration to evaluate and select *mudarib* that have huge potential to succeed and have a lot of experience and skills to conduct the business.

The selection can be very challenging because it needs a comprehensive study to cater to the problem on the aspect of risks. A company that has a 'clean' record of financing and performance may be their potential partner. However, if they only select big companies as their selected partner, what will happen to the small company that has no experience and finance? This selection can be contradicted in the context of Islamic banks since the establishment of Islamic banks are to promote justice and bridge the gap between the poor and the rich.

4.2.1.4. Dhaman (Guarantee)

As mentioned earlier, the funds provided by the banks are mainly from the depositors. Thus, the safety of the capital needs to be ensured as it is very essential in the event of default or any loss that happens. This guarantee can determine their honest commitment and determination to ensure the business is on the right track. For instance, the guarantee can be in the form of collateral that is highly secured (Abdul-Rahman and Nor, 2016). Therefore, the probability of moral hazard and fraud can be reduced if there is collateral as a form of guarantee. Unfortunately, since the partner that requests the finance is the one that is lacking in capital, they may not afford to provide the guarantee needed. Hence, it really demonstrates the challenge that needs to be taken into full consideration before implementing *Musharakah* and *Mudarabah* by the Islamic banks.

4.2.2. From a Regulatory Perspective

From a regulatory perspective, the risk-sharing schemes such as in *Mudarabah* and *Musharakah* contracts also consider promoting shared prosperity among the various stakeholders based on allocative efficiency and equity (Adewale and Archer, 2019). However, regulator considering the application of funds with PLS scheme poses a high risk. These risks, which appear at various stages of transactions, may change in nature and may necessitate a comprehensive and sound risk management infrastructure, reporting and control framework (BNM, 2015). Further, an Islamic bank that acts as a partner in a *Musharakah* contract will be exposed to the risk of losing its share of capital, to capital impairment risk or to credit risk, depending on the structure and purpose of the *Musharakah* and the types of asset in which the funds are invested (Onagun, 2017).

The unique nature of Islamic banking products and operations requires banking regulators to comprehensively evaluate and set up regulations and provisions that could promote, guide and support the industry initiatives; among others are the principal guidelines of PLS scheme and the capital requirement relating to such scheme. This part will focus on both issues and compare the implementation in two countries, i.e. Malaysia and Indonesia.

4.2.2.1. Guidelines on Profit and Loss Sharing Scheme

National regulatory bodies, such as BNM in Malaysia and *Otoritas Jasa Keuangan* (OJK) or Indonesia Financial Services Authority (IFSA) in Indonesia, have also issued guidelines relating to PLS sharing scheme. BNM issued Shariah Standards and Operational Requirement on *Mudarabah* and *Musharakah* in 2015 respectively. The standards are intended to promote transparency and consistency of Shariah contract application which would enhance the contracts' certainty and strengthen Shariah compliance by Islamic banks in Malaysia. Meanwhile, OJK has issued OJK Circular Letter regarding the Codification of Islamic Banking Products and Activities in 2015. The regulation was aimed to assist the Indonesian Islamic banking industry in formulating and offering Shariah-compliant products, both funding and financing products and services. It also regulates the utilization of *Mudarabah* and *Musharakah* contract in funding and financing products.

Based on these two national regulatory approaches, there are some similarities and differences in the *Musharakah* and *Mudarabah* guidelines which could stimulate Islamic banks to offer such financing products, as described in Table 1.

The BNM guidelines consist of two components, i.e. the Shariah and the operational requirements. The Shariah requirements focus on the salient features and essential conditions of a specific contract, while the latter outlines the core principles underpinning good governance and oversight, proper product structuring, effective risk management, sound financial disclosure and fair business and market conduct (BNM, 2015). While the OJK regulation provides general rules for using Islamic contracts in banking products and services. Unlike BNM guidelines, the other aspects like risk management and good governance for each contract are provided in other OJK regulations.

Table 1: Comparative BNM and OJK Guidelines on *Mudarabah* and *Musharakah*

Issues	BNM Shariah and the Operational Requirements of <i>Musharakah</i> and <i>Mudarabah</i>	OJK Circular Letter Codification of Islamic Banking Products and Activities
Regulation coverage	The Shariah Standards consist of two components – the Shariah Standards and the Operational Requirements.	Only regulates the operational requirement. The Shariah principles are based on the <i>fatwa</i> issued by the National Sharia Council (DSN) - Indonesian Ulema Council (MUI)
Source of funds	For <i>Musharakah</i> and <i>Mudarabah</i> venture, the sources of funds from deposits are not allowed. Hence, only allows funding from Unrestricted and Restricted IA or shareholders' fund.	No restriction.
Profit and loss Sharing Ratio (PSR) determination	Based on the estimated return on the <i>Musharakah/Mudarabah</i> venture; benchmark rate of return of the equivalent product; and estimated management or operational costs incurred by the managing partner in managing the <i>Musharakah/Mudarabah</i> venture.	PSR is pre-agreed and cannot be changed during the tenure unless there is an agreement of gradual review. The PSR can be agreed on a tiering basis. OJK allows 3 types of profit-sharing method, i.e. profit sharing, revenue sharing, net revenue sharing.
Tenure	The tenure must be specific. Any <i>Musharakah</i> ventures that are perpetual in nature shall be subject to approval and assessment by BNM on a case-by-case basis.	The financing tenure and profit-share distribution based on the Islamic bank and customer agreement. There is no restriction on perpetual tenure.
Collateral requirement	Both <i>Musharakah</i> and <i>Mudarabah</i> ventures may require collateral or a guarantee. However, it shall only be liquidated in the event of misconduct (<i>ta`addi</i>) or negligence (<i>taqsir</i>) or breach of specified terms (<i>mukhalafah al-shurut</i>) of a contract by the partner(s)	Islamic Banks may require collateral, which could only be liquidated in the event of misconduct, negligence, or any breach of the pre-agreed agreement.

Source: (BNM, 2015a, 2015b; OJK, 2015)

4.2.2.2. Capital Requirements to Mitigate the Risks

Considering the inherent risks of the PLS scheme, the regulator requires more capital to be provided by Islamic banks against the risk exposures than is required for exchange-based financing. The study of Adewale and Archer (2019) found that the regulatory provision on capital requirements had affected the willingness of the Islamic banks to offer risk-sharing financing contracts. However, the study concluded that the capital requirement should not be viewed as a hindrance to risk-sharing contracts with Islamic banks. Based on the IFSB theoretical model developed within a profit maximisation framework, an increased capital requirement under Basel III and IFSB-15 make Islamic banking appear better capitalised (Adewale and Archer, 2019).

The capital requirements for such contracts were originally initiated by the Basel requirements to increase the quality and quantity of the regulatory capital requirements and to introduce countercyclical and capital conservation buffers in order to address systemic risk and interconnectedness (IFSB, 2013). Basel requirements shall be implemented to all banking institutions and IFSB has drawn up some recommendations for Islamic banks. As well as Basel, IFSB guidelines also allow national regulators to implement local adjustments to the Islamic banks in their jurisdictions (Spinassou and Wardhana, 2018).

One of Basel's requirements is related to equity exposures, including both direct and indirect ownership interests. Considering the risks evolved in equity exposures, Basel requires calculation for risk weight under the simple risk-weighted method, which is a 300% of risk weight to be applied to equity holdings that are publicly traded and a 400% of risk weight to be applied to all other equity holdings (BCBS, 2018).

To accommodate Basel capital requirements, IFSB has issued IFSB 15 Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Collective Investment Schemes]. It suggests that Islamic banks offering *Musharakah*,

are exposed to the entrepreneurial risk of an active partner that manages the partnership and business risks associated with the underlying activities. In the simple risk-weighted method, such scheme entails a 400% of risk-weighted (IFSB, 2013). In the same vein *Mudharabah* will also bear 400% of risk-weighted for private commercial enterprise and *Mudharabah* investment in project finance (IFSB, 2013). It means that the Islamic bank has to provide four times of capital amount for the *Musharakah* financing. Hence, the Islamic bank assuming this type of financing will burden its capital.

However, *Musharakah* and *Mudharabah* financing can be funded by deposit accounts, Unrestricted or Restricted Investment Account Holder (IAH) or Profit-Sharing Investment Account (PSIA). Assets financed by unrestricted or restricted IAH/PSIA do not pose a risk for the bank's capital and thus not subject to a cost of capital charge (zero capital charge). However, the Islamic banks will be entailed with capital requirements for PLS financing funded by the bank's capital and deposit from customers.

The BNM Capital Adequacy Framework for Islamic Banks was issued in May 2019 adopting both Basel and IFSB recommendations specifically in the measurement methodologies for the purpose of calculating RWA for credit risk, market risk and operational. In this regard, BNM provides guidelines of RWA calculation approaches, i.e. the standardised approach and the Internal Rating Based (IRB) approach. BNM imposes a lesser risk-weighted calculation compared to IFSB-15 for both *Musharakah* and *Mudharabah* exposures under the standardised approach. BNM capital requirements show its support for Islamic banks in Malaysia to offer *Musharakah* and *Mudharabah* schemes by providing such an incentive.

Indonesia has also adopted IFSB-15 for PLS financing as regulated in its Circular Letter regarding to Credit Risk-Weighted Assets Requirements Using Standardised Approach for Islamic Banking issued in 2015. In summary, Table 2 compares the regulatory approach taken by BNM and OJK following the IFSB-15.

Table 2: Comparison of IFSB, BNM and OJK Capital Requirements

IFSB-15	BNM Capital Adequacy Framework	OJK Circular Letter Credit Risk-Weighted Assets Requirements
Both <i>Mudharabah</i> and <i>Musharakah</i> ventures are 400% risk-weighted for shares that are not publicly traded less any specific provisions for impairment	<ul style="list-style-type: none"> - 100% risk weight for publicly traded equity - 150% risk weight for non-publicly traded equity; - For advanced and larger equity portfolio, based on the Internal Rating Based approach, entails 400% risk weight. 	Based on the external rating of the customer or 400% for unrated customers.
Assets financed by Unrestricted or Restricted IAH may carry a zero-capital charge	Not Applicable	<i>Musharakah</i> and <i>Mudharabah</i> financing funded by Restricted IAH is required 1% of risk-weighted.

Source: Authors' compilation

4.2.3. From an Entrepreneur/Venture or Customer Perspective

The customer is an important element to support and sustain the business. There is an argument that customer's preference, as an external factor contributes to the low-level adoption of PLS financing, especially through *Mudharabah* and *Musharakah* contracts (IFSB, 2019b). A survey was done among the Islamic banks and only 15% of the banks disagree with the statement while the majority of the banks agree that customer's lack of interest in the PLS model of financing leads to the low-level offering of the product. On the other hand, other research said that customer as an external factor is unlikely to be the main reason for the almost non-existence of PLS financing in the market, rather it is the decision of the internal division-top management, risk management- to not offer this product (Muhammad, 2014). The author leans more toward Muhammad (2014), considering the fact that the survey done by (IFSB, 2019b) was participated by banks and not customers; thus the opinion or result is a reflection of the bank's opinion and perspective and not the consumer. To get the actual customer's perspective about certain products or types of banks and to understand the factors affecting customer's choice in banking and product consumption, further discussion regarding customer's behaviour needs to be done.

4.2.3.1. Bank Reputation

Bank's reputation is one of the common things that customers will consider when selecting a bank among its competitors (Selvanathan et al., 2018). A good public image of a bank is one of the factors affecting consumers in choosing a certain type of bank and using their product (Bushman and Wittenberg-Moerman, 2012). Past researchers, like Echchabi and Olaniyi (2012) found that a bank's image in the market is the most vital criteria taken into consideration by consumers when choosing a bank. Building a pleasant reputation of a business is heavily related to customer's experience, trust, and loyalty. A positive customer's experience equals to earning their trust and loyalty. Bad bank's performance will not only damage the institution's reputation (Muhammad, 2014) but the possibility of customers changing to a different bank is high.

Among others that play a crucial role in an excellent customer's experience in the market is related to the quality of service offered by a financial institution. It is well known that the Islamic banking system is the literal reflection of its conventional counterpart with the exclusion of non-Shariah compliance elements. Regardless of the banking system, both of the banks will likely offer the same product and services. The only competition between the two is through customer satisfaction. Fast and efficient service in transaction and friendly staff are among the elements that contribute to great customer satisfaction. In fact, a survey was done by (Siddique, 2012) to 600 customers in Bangladesh showed that effective and efficient customer services, speed and quality services; the image of the bank, online banking, and well management are the top components influencing the consumers in choosing a bank.

4.2.3.2. Price of Product and Services

Pricing is probably one of the most common aspects taken into consideration by the consumer before choosing a certain bank or product because it is a cost that needed to be paid in return for the benefit. Although technically there is not much difference between the prices of each bank due to the benchmarking issue against the conventional rate, a bank can still offer a unique price by managing their cost that will reflect in the pricing.

Customers are usually more price-sensitive. They are aware of the prices offered by different banks in the market before choosing their financial institution or even product. They would certainly demand a better quality of product with the lowest cost or price possible (Selvanathan et al., 2018).

4.2.3.3. Religion

Despite the Islamic banking system being a reflection of the conventional system, the exclusion of non-Shariah elements is the motivation for customers, primarily Muslim customers to choose Islamic banks and use the product offered. A lot of past researchers had pointed out the involvement of religious value in the customer's decision-making process (see; for example, Ahmad et al., 2020; Haron et al., 2020).

4.2.3.4. Awareness and Knowledge

The lack of awareness and knowledge from the customer might be one of the reasons for the insufficiency of PLS financing in the market. Knowledge of Islamic finance is still lacking in society. Despite the robust growth in the Islamic financial system, this does not reflect in the level of knowledge owned by the society in general. They fail to differentiate between Islamic and conventional systems (Nik Muhamad et al., 2013). It is vital for the customer to have the knowledge for them to use and purchase the products and services.

Awareness among potential users is also a crucial issue. Institutions should always disclose all information necessary about their operations and product (Maali et al., 2006). Disclosure and promotion by the bank will eventually promote awareness among customers. High awareness from the customers will affect their response to their own preferences and awareness is the main contributions to customer's preferences (Nik Muhamad et al., 2013).

4.2.4. The Way Forward

The conventional banking system existed and was developed since the 16th century and since then it has had a fixed and standardized operating and management system which is not easy to change. Bankers, regulators and the public are familiar with the term and operational banking as an institution that carries out activities that are usually done by the banking system developed many years ago. Over time, Muslim realized that this

banking system was merely a system built by men from the West and was not fully in accordance with some Islamic teachings.

Banking activities, such as those carried out by westerners, were not known at the time of the Prophet and the Islamic era. However, the founders of the Islamic bank realized that it was impossible to establish an Islamic bank which operations were much different from the conventional banks known at that time. This condition encouraged the founders of Islamic banks to introduce Islamic banking by using the fundamentals of conventional bank operations and eliminating things that violated Shariah principles. Islamic banking was then introduced as a complement to the conventional banking system. Therefore, they tend to offer Islamic banking products that were not much different from conventional banking products. They also operate and manage their bank operations under conventional bank best practice operations. This approach was taken by many jurisdictions in the early stages of the development of Islamic banking and finance.

After 30-40 years later, Islamic banks exist and are better known as a complement to the banking system, including in Malaysia, where Islamic bank assets account for almost 40% of total banking assets. Financing products dominated by exchange-based contracts are argued to have the same impact on the economy, such as those caused by interest-based credit. Some researchers argue that currently Islamic banks have not fully implemented the principles of Islamic finance because of the low portion of PLS financing schemes. Islamic banks are dealing with the same types of consumers as conventional banks, causing intense competition. Instead of offering unique products, Islamic banks try to offer products that have been offered by conventional banks by making some adjustments to comply with Shariah principles. Islamic banks have become less innovative and reluctant to develop products that are different from conventional banks.

Considering today's challenges and opportunities, it is time to change people's mind-set about Islamic banking and become familiar with the PLS scheme. A change of mind-set must be conducted by Islamic bankers, the regulator and also Islamic bank's consumers. A PLS scheme should be introduced as a fair and profitable scheme for banks and entrepreneurs, which will contribute to the growth of the economy.

Moving forward, Islamic banks must improve their quality of human resources, from the front-liner level to the highest level of management. Many Islamic bankers initially worked for conventional banks and had to change their conventional bank mind-set to an Islamic one. It is important to have employees and the board of management who are willing to always uphold Shariah principles in every stage of product development and operations. Better knowledge and understanding of Shariah principles will help them to better explain the PLS scheme to the customers. Next, Islamic banks must continue to educate the public about Islamic finance, specifically the concept and practice of PLS schemes. This approach shall be done continuously with the regulator, government and academicians. Subsequently, as a business entity, Islamic banks have to improve their operation. Aforementioned that many Islamic banks are reluctant to offer such schemes because of the high risk. On the other hand, risk must be correlated with returns. Therefore, with a proper risk management system, Islamic banks must be able to reduce the risk associated with the scheme. Furthermore, unlike conventional banks which always transfer their risks as much as possible, Islamic banks must change their intention not to transfer risk but to share the risk.

In some cases, banks are also reluctant to offer *Mudarabah* and *Musharakah* financing because of difficult financing evaluation process and high operation costs, such as monitoring cost and collection cost. For instance, when an Islamic bank offers a *Mudarabah* financing to an entrepreneur, it requires a deep understanding and analysis of the business. It will not be easy for Islamic banks to provide their officer with such expertise. Further, upon the financing approval, the Islamic bank will ask for a monthly financial report that informs the profit or loss earned by the entrepreneurs during the month. The document will be the basis for calculating the profit-sharing between the bank and the entrepreneur. Collecting these documents manually can be a burden to the bank, especially if the customer does not always provide them voluntarily. Therefore, Islamic banks can start using financial technology (fintech) to automate and digitalize their operations, such as smart contract, block-chain technology, peer to peer lending and crowdfunding. Lastly, Islamic banks must always be fair to their customers, as well as the customer must always maintain trust with the bank. The consent of both parties will reduce the problem of asymmetric information and moral hazard between the parties.

Efforts to improve the application of the PLS scheme in Islamic banking must also be contributed by the central bank or financial regulator. They must be consistent in developing and improving the regulatory framework for Islamic banking, which intends to provide the same level of playing field as conventional

banks without neglecting the unique characteristic of Islamic finance. These regulators and government can also take another approach to encourage Islamic banks, such as imposing incentives and disincentives for Islamic banks to provide PLS financing scheme.

Lastly, as customers of Islamic banks, they must be open-minded and take the opportunity to contribute to developing a PLS sharing financing scheme. It is the obligation of the Islamic banking industry to increase its customers' awareness and understanding on the scheme. By enhancing the level of apprehension among customers, the demand side of the equation will be affected directly and further raises the percentages of PLS finance adoption in the market. This can be done simply by taking advantage of various existing media platforms, for instance, using the advertorial method, radio/ TV talk show, public hearing, exhibition, campaign and many more.

5. Conclusion and Recommendations

Profit-loss sharing is the ultimate principles of Islamic finance which is believed to bring prosperity and unlock economic potentials. However, due to several associated risks, asymmetric information problems and moral hazards, as well as some difficulties on the financing evaluation process, many Islamic banks are still less preferable to offer financing products with such underlying contracts i.e. *Mudarabah* and *Musharakah* financing schemes. In addition, from a regulatory perspective, risk-sharing scheme between banks and their customers should be a fundamental principle that underlies the potential of Islamic banking to ensure financial stability and to strengthen the link between the real and financial sectors. However, regulators require more capital to be provided by Islamic banks against the risk exposures than is required for exchange-based financing. Nonetheless, Islamic banks should not interpret the additional capital requirement as a hindrance in providing PLS contracts. Lastly, from a customer perspective, it is arguable that the customer as the external factor is the main factor of the low-level adoption of PLS financing. Customers do not choose this mode of financing not because of their individual preferences but due to a lack of information about the products. Therefore, it is an obligation of the Islamic banking industry to raise awareness and educate their customers.

This study recommends that all parties must change their mind-set about Islamic banking operations that do not necessarily have to operate in the same way as conventional banks. Islamic banks may encounter a higher risk to obtain a higher return, as they have to share risk with their customers rather than transferring risk as their conventional counterpart does. Therefore, a sophisticated Islamic risk management system is needed to mitigate the potential risk without neglecting the Shariah principles. As part of the risk management, Islamic banks can adopt fintech, such as smart contracts, block-chain technology, to build an efficient financing process so as to reduce the problem of asymmetric information and moral hazard. Meanwhile, regulators must increase their roles in developing a regulatory framework that supports the Islamic banking industry by issuing regulations and incentives that encourage the implementation of PLS schemes in the Islamic banking industry. Finally, increasing public awareness and knowledge about the PLS scheme must be continuously carried out by all market players in the Islamic banking industry.

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