JOURNAL OF ISLAMIC FINANCE

VOLUME 9 NUMBER 2

DECEMBER 2020

ISSN: 2289-2109
E-ISSN: 2289-2117

IIUM Institute of islamic Banking and Finance
IIUM Press, International Islamic University Malaysia

https://journals.iium.edu.my/iiibf-journal/index.php/jif

JOURNAL OF ISLAMIC FINANCE

AIM AND SCOPE OF JOURNAL OF ISLAMIC FINANCE
Journal of Islamic Finance (JIF), published biannually (June and December), is a double blind peer-reviewed open-access journal of the IIUM Institute of Islamic Banking and Finance, International Islamic University Malaysia (IIUM). The journal is designed to provide a platform for researchers, academicians and practitioners who are interested in new knowledge and discussing ideas, issues and challenges in the fields of Islamic banking, finance, accounting, business and economics. The scope of the journal includes, but is not limited to, Islamic banking and finance, Islamic capital market, Islamic wealth management, issues on Shariah implementation and practices of Islamic banking and finance, zakat, waqf, takaful and comparative analysis of Islamic and conventional financial institutions.

REFEREES' NETWORK
All papers submitted to the Journal of Islamic Finance will be subjected to a rigorous reviewing process through a worldwide network of specialized and competent referees. Each accepted paper should have at least one positive referee's assessment.

SUBMISSION OF A MANUSCRIPT
A manuscript should be submitted online to the Journal of Islamic Finance at https://journals.iium.edu.my/iiibf-journal/index.php/jif/login. Further correspondence on the status of the paper could be done through the journal website.

Published by:
IIUM Press
International Islamic University Malaysia
Jalan Gombak, 53100, Kuala Lumpur, Malaysia
Phone: (+603) 6421-4185, Fax: (+603) 6421-4856

Journal of Islamic Finance
ISSN: 2289-2109 E-ISSN: 2289-2117

JOURNAL OF ISLAMIC FINANCE

Volume 9 Issue 2, 2020

Table of Content

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 1-12
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

An Integrative Model of Waqf, Sadaqah and Takaful for Poverty Alleviation through Empowering Women Farmers in the Rural Gambia

Muhammed Hydara

Office of the Vice-Chancellor, University of the Gambia, Kanifing, The Gambia

mhydara@utg.edu.gm/muhammedhydara@hotmail.com

Abstract

The agony of poverty on the globe is rather a perplexing one; despite the growth of global economies and advances in science and technology, yet over 700 million people is living in extreme poverty globally. Approximately 241 million are from the Organisation of Islamic Cooperation (OIC) countries, with just 9 of the Low-Income countries accounting for more than 40%. Despite these interesting statistics on poverty, the OIC countries housed more than two-thirds of the world's energy resources and 40% of its natural resources and yet accounts for more than half of the countries under the Low Human Development Index (HDI). According to the World Bank estimates, the COVID-19 pandemic could push about 70-100 million people into extreme poverty. The pandemic is drastically changing the poverty dynamics globally with Sub Saharan African countries deem to be the most affected. The Gambia, a member of the OIC and Sub Saharan African, has 48% of her population living below the poverty line with an HDI ranking of 174 out of 189. The Gambia produces only half of the food it needs, with acute malnutrition at 10%, and 23% of children are stunted. As conventional policies have been deployed over the years to fight poverty, it is only fair to raise the curtains on the potentials of Islamic Social Financing that can also complement the global efforts in eradicating poverty. As a conceptual paper, this study employed qualitative methods to present the potentials of agricultural investment through a hybrid model of waqf, sadaqah, and takaful to aid women farmers of the rural Gambia in financing their agricultural activities.

Keywords: Poverty, COVID-19, agricultural investment, waqf, sadaqah, takaful

1. Introduction

1.1 Global Poverty Level

Despite the vast improvement in the economic well-being of billions of people, about 10% (736 million people) of the world's population still dwell in extreme poverty (i.e. less than US$1.90 a day), 50% of which are under 18 years of age, 80% of people living on less than US$1.90/day, resides in South Asia and Sub-Saharan Africa and 1.3 billion people are living in multidimensional poverty (UNDP, 2020). The majority of these people are vulnerable to climate change disasters, disease outbreaks, increased crime rates and other social vices. Hence, the level of obnoxious situation instigated by poverty gave rise to inequality and an avenue for social strife.

Islamic Finance has recently registered positive progress growth with a global asset of about US$3 trillion IFSB (2019). However, it is failing to adequately address the alarming level of poverty in the Organisation of Islamic Cooperation (OIC) countries. This is due to the inadequate creation of sufficient economic activities among member countries to lift the poor and destitute out of this obnoxiousness. Despites a total of 57 member countries the OIC accounts for almost one-fourth of the world's population. Despite that, the aggregate GDP of these member countries accounts for less than 9% of the global GDP. According to COMCEC (2019), approximately 241 million people are living under US$1.90 a day in OIC countries, with

Article history:
Received 6 November 2020
Revised 15 December 2020
Accepted 22 December 2020

just 9 of the Low-Income countries accounting for more than 40%. Despite these interesting statistics on poverty, the OIC countries housed more than two-thirds of the world's energy resources and 40% of its natural resources and yet accounts for more than half of the countries under the Low Human Development Index (HDI).

1.2 State of Poverty and Agricultural Development in the Gambia

As a member of the OIC, about 48% of Gambia's population lives in poverty with an HDI ranking of 174 out of 189. According to the World Food Programme (WFP) (2019), Gambia produces only 50% of the food it needs, with acute malnutrition at 10.3%, while 23% of children are stunted. Agriculture serves as the major economic growth driver in the Gambia, contributing over 20% of the GDP and providing employment and income for over 70% of the population. Farming activities serve as the main source of income for the majority of the populace living in the rural that rely on erratic rainfall. Despite the viability of the agricultural sector, farming activities are vulnerable to climate change crisis such as erratic rainfalls, drought, floods, lack of farm implements and inadequate farming skills, which subsequently impact the availability of food supply (WFP, 2019).

Agriculture is one of the most important sectors in the Gambia for economic development. The crop-sub sector alone generates about 40% of the foreign exchange earnings. Also, about half of the population dwell in rural areas, and agriculture remains a predominant source of employment and economic growth along the value chains, from production, processing to marketing. Crop production provides about 75% of the household incomes and employs 70% of the labour force, accounting for over 20% of the GDP (FAO, 2019).

Women comprise 78% of the economically active population who work in agriculture compared to 57% of men. Although more women than men work in agriculture, they, however, are not accorded the same rights as men, such as land, credit, implements, technology, and access to markets (FAO, 2019). The growth in the agricultural sector is about half of the national target because of the insufficient investment and inadequate output, which is aggravated by persistent gender inequalities and inaccessibility to farm inputs. The most exposed people are regularly at the peril of being unable to procure sufficient food. Crop production fell by 26% because of long dry spells in 2017 (WFP, 2019). Aggravating to this, fluctuating market prices had detrimental effects for vulnerable households, who spend half of their meagre income on food. Therefore, the intervention of Islamic social financing instruments like waqf, sadaqah and takaful can improve the agricultural sector and, consequently, the living standard of the people as the Gambia is a Muslim majority country.

2. Literature Review

The prominence of agricultural productivity in reducing poverty, especially in the Least Developed Countries (LDCs) like the Gambia and many other Sub-Saharan African countries, is well recognized in academic literature. The majority of the households in Sub-Saharan African countries depend on subsistence agriculture for their livelihood. However, the striking level of poverty in these regions impedes the ability of these people to realise the full potentials of agricultural productivity. Hence, enhancements in agricultural activities like mechanisation, higher quality improvement in farming techniques, and crop yields will significantly impact the lives of these indigenous since the majority of them are involved in it to provide a living for their families.

2.1 Empirical evidence of poverty alleviation through an upsurge in agricultural productivity

Agricultural productivity has been defined as a measure of total output per hectare, per unit of input, yield, or worker. However, according to Mellor (1999), "*regardless of which measure is used, empirical studies support the idea that improvements in agricultural productivity are important for poverty reduction*". Schneider and Gugerty (2011) identified in their literature that there are several paths via which upsurges in agricultural productivity can mitigate poverty, including employment generation, rural non-farm multiplier effects, real income changes, and food price effects. However, these are hindered by lack of technology adoption, initial asset endowments, and constraints to market access may all inhibit the ability of the poorest to participate in the gains from agricultural productivity growth. Dhahri and Omri (2020) concluded that ending poverty and hunger in developing nations depends on the development of the agriculture sector, the inflows of FDI, and the composition of foreign aids given to the host countries.

Extensive literature has backed with empirical evidence that agricultural productivity significantly reduces the level of poverty. Dhahri and Omri (2020), Datt and Ravallion (2007), Byerlee et al. (2005) and Timmer (1995) all did studies on the impact of agricultural productivity on poverty reduction using a variety of productivity measures, and all the results point to a significant reduction in poverty. According to Badibanga and Ulimwengu (2020) in their study on agricultural productivity and poverty concluded additional agricultural investment coupled with improved agricultural inputs productivity will speed up a country's pace toward achieving growth and poverty reduction targets. Irz et al. (2001) stated that a percentage of growth in agricultural productivity reduces the poverty headcount ratio by about 1% to 2%. Equally, Irz et al. (2001) found that every 1% increase in agricultural GDP leads to a 1.61% increase in the incomes of the poorest quintile. Moeis et al. (2020) and Thorbecke and Jung (1996) in their study on poverty in Indonesia also concluded that the majority of poverty reduction is as a result of massive growth in agricultural productivity.

According to Mellor (1999) and Dhahri and Omri (2020), an increase in agricultural production (output) will lead to lower food prices, an increase in farmers' income, which will result in their increased demand for the goods and services produced by the non-farming rural poor, hence, the multiplier effect. Thirtle et al. (2003) and Moeis et al. (2020) also mentioned that agricultural growth by increasing both production and employment gave rise to a significant benefit for both poor farmers, landless labourers, and the rural poor through the non-farm economy.

Schneider and Gugerty (2011) explained the multiplier effects of how an increase in agricultural productivity on the respective stakeholders and the economy at large can alleviate poverty. This explains that an increase in agricultural productivity will lead to increased output. Hence, a decreased in real food prices and increasing demand for food result in increased on-farm employment. These will result in an increased farm household real income, hence, triggered the demand for non-food goods and services, which give rise to off-farm employment. This increase in non-farming household real income causes an increase in real wages that cause a decrease in the poverty level.

In the case of the Gambia, this multiplier effect will result in an increase in both on-farm and off-farm employment with an increase in real income, thus, enabling these women, who are mostly the bedrock of their families, to be able to provide food for the family and send their children to school. However, the poverty among these women causes the stoppage of their children's education, and in some families, all the children have to stop schooling as a result of the dilemma of sustenance, education, and healthcare. Therefore, the impact of agricultural productivity in alleviating poverty cannot be overemphasised in the Gambia and other Least Developed Countries.

2.2 Islamic Social Finance Instrument

This study aims at establishing the connection between agricultural investment and productivity. Hence, the paper proposes an unconventional model of financing agricultural investment through Islamic Social Finance (ISF) tools. The proposed model will deploy the ISF concepts and instruments in the form of waqf (Islamic endowment), sadaqah (voluntary charity), and takaful (Islamic insurance). The main tool of the proposed model (WST-Hybrid Model) will be centred on waqf, supported by sadaqah and takaful. This is because the waqf properties or resources may not be enough or available at the same time and because sadaqah as a voluntary charity comes in many forms and can qualify as little as removing a stone on the pathway. Sadaqah will serve as a buffer in raising funds as it can be raised and distributed without much restriction.

Hence, through sadaqah, people with expertise in agriculture can volunteer by transferring their expertise through training and mentorship to farmers. On the other hand, the takaful will serve as a safety net for the sustainability of the model. This will be the vehicle through which part of the income generated from the returns of the agricultural investment will be invested into the takaful scheme and serve as a protection and support for farmers who may experience poor productivity. Therefore, the sadaqah and takaful as ISF tools are relevant to the model as they provide support and sustainability

2.2.1 Waqf

Waqf (plural Awqaf) refers to an endowment made by a Muslim for a religious, educational, or charitable cause. It also means detaining, withholding, or retaining an asset, for instance, like a property, land, cash, or cash equivalent, to deter it from been saleable and alienable while directing its usufruct to a legal channel of spending (Elasrag, 2017). According to Kahf (2015), waqf refers to "holding certain property and preserving it for the confined benefit of certain philanthropy and prohibiting any use or disposition of it outside that specific objective". Muhammad (2015) stated in the Arabic language, the term waqf means "*habs"* (to obstruct, shut off, confine or retain). In the Islamic law, it means to retain property that is specific and owned whose ownership is transferable and it can be benefitted from while the property itself remains, and this is by spending disposal of it, while the financial proceeds go towards something permissible and existent.

According to Magda et al. (2016), waqf is referred to as a "financial charitable act established by withholding immovable and movable properties to perpetually spend its revenue to fulfil public or family needs, based on the preferences and conditions set by the founder. Once the property is created as a waqf, it can never be given as a gift, inherited, or sold. It belongs to Allah (SWT), and the waqf property remains intact. Only its generated revenue is channelled to its beneficiaries". As an imperative socio-economic development instrument, hence, if implemented appropriately, the results can be drastic in alleviating poverty and improve the living standards of people. Waqf has been in existence since the pre-Islamic era; however, it begins to flourish and innovatively administered during the Islamic era up to the 19th century. It was estimated that awqaf properties in terms of agricultural lands in certain Muslim communities like Turkey (Ottoman caliphate), Egypt, Syria, and Morocco were up to more than two-thirds of the total land. Hence, these countries use these said properties to address the economic problems of their people by reallocating such resources from existing consumption to invest into productive areas that create revenues for future consumption of their people, hence, the economic perspective of waqf. Thus, waqf, in an economic sense, indicates a sacrifice of an opportunity cost between present consumption and investment for future consumption (Kahf, 1998).

Although there are no direct rulings on waqf in the Quran, the hadith provides a detailed description of waqf, as narrated in the following hadith and numerous others;

(1) *Ibn Umar reported: Umar acquired land at Khaibar. He came to Allah's Apostle (may peace be upon him) and sought his advice regarding it. He said: Allah's Messenger, I have acquired land in Khaibar. I have never acquired property more valuable for me than this, so what do you command me to do with it? The Prophet (S.A.W) said: If you like, you may keep the corpus intact and give its produce as Sadaqah. So Umar gave it as Sadaqah declaring that the property must not be sold or inherited or given away as a gift. And Umar devoted it to the poor, to the nearest kin, and to the emancipation of slaves, aired in the way of Allah and guests* (Sahih Muslim: Book 13, No. 4006).

*(2) Uthman ibn Affan narrated that he heard Allah's Messenger (SAW) say, "If anyone builds a mosque for Allah then Allah will build for him the like of it in Paradise." (*Sahih Muslim: Book 4, No. 1084).

2.2.1.1 Types of Waqf

The scope of awqaf is colossal and comes in various forms and kinds; however, for this study, we will limit our focus on the property and cash form of waqf. Property waqf is the most common form of awqaf, and it is a waqf where the bequeathed assets are in the form of physical assets like housing, buildings, mosques, hospitals, education centres, orchards, farmlands, and other beneficial properties for the community. As waqf properties cannot be given as a gift, inherited, or sold hence, they become inalienable and perpetual for communal beneficent.

As a modern type of awqaf, "cash waqf" is quite distinct from the other forms; here, the bequeathed asset is in the form of cash. Hence, it is imperative to note that waqf properties are not limited to only immovable but movable assets, too, as explained by Magda et al. (2016). According to Lahsasna (2010), "cash waqf is a mobilization fund from donors based on perpetuity and investing them in productive assets that provide either usufruct or revenues". Thus, the redistribution or apportioning of such funds to agricultural activities, especially for women empowerment and poverty alleviation, can be a productive venture and a path towards achieving SDG 1.

2.2.2 Sadaqah (Voluntary Charity)

Sadaqah is an Arabic word derived from the word "*Sadq,"* which referred to truth or righteousness. In Islam, all righteous actions are considered as sadaqah, even the removal of a harmful object from the footpath. Sadaqah refers to the spending from one's belongings and capabilities in the way of Allah (SWT) (to help the poor, needy, orphan, destitute, etc) in seeking His pleasure and mercy. Hence, sadaqah plays an integral part in the life of a Muslim's faith. The holy Quran affirms this in the following verse (Al-Baqarah: Verses 261 and 277) respectively;

"The example of those who spend their wealth in the way of Allah is like a seed which grows seven spikes, in each spike is a hundred grains. Allah multiplies His reward for whom He wills, for Allah is vast and knowing".

"Indeed, those who believe and do righteous deeds and establish prayer and give zakah will have their reward with their Lord, and there will be no fear concerning them, nor will they grieve".

According to Bensaid and Grine (2013), "Charitable spending is not limited as means of spiritual purification, but also as an instrument for building socio-economic sustainability and social reforms resulting in the well-being of an individual and society in the world and hereafter". Therefore, extending a hand in support of women vendors and farmers to get established, financing the schooling of orphans, providing food, shelter, and clothing for the destitute, settling the medical bills of patients, reaching out to the community, and providing assistance in the provision of clean drinking water, milling machine centres, building schools, hospitals, markets, roads, etc., all this fall under the purview of "*sadaqah-tul jaaria*" (an everlasting charity).
The benefit of sadaqah is not limited to the spiritual world but the material world too; hence, it serves as a deterrent and protection against different kinds of evil and related negative afflictions of this world. Sadaqah expiates sins and prevents punishment on the Day of Judgement. Therefore, these abundances of dual benefits for both worlds and the inclination of Muslims towards sadaqah will only continue to grow, hence, contribute to the sustainability of the socio-economic status of the society and institutions (Htaya et al., 2013).

2.2.3 Takaful (Islamic Insurance)

Takaful is a word derived from the Arabic verb "*Kafala,"* which means to take care of one's needs (Zulkifli et al., 2012). Therefore, the contract between at least two parties agreeing to jointly guarantee one another in the event of a loss, as a consequence of being afflicted by a calamity, defines the term takaful. However, the origin of takaful can be traced back to over 14 centuries ago in the Arabian Peninsula of Mecca during the pre-Islamic era where it was a custom of the pagan Arabs for a killer to pay blood-money as compensation to the family of the slew. Later on, this custom was approved by Prophet Muhammad (S.A.W.) due to its merit to avoid feud and war among the community.

Islamic Financial Services Board (2009) defined takaful as the "Islamic counterpart of conventional insurance and exists in both Family (and "Life") and General forms. Takaful is derived from an Arabic word that means a joint guarantee, whereby a group of participants agrees among themselves to support one another jointly for the losses arising from specified risks". Hence, conceptually takaful is a form of insurance but one that is participatory and based on risk-sharing by parties on a cooperative principle rather than a risk transfer to a third party as in the case of conventional insurance.

As one of the most vulnerable sectors, the agricultural industry usually encounters issues related to drought due to erratic rainfall causing extreme temperature, pests, and diseases, etc., which usually affect the quality and yield of the crop production. There is also a potential risk of fluctuation in market prices of commodities due to various macroeconomic factors. These challenges can only get severe for the women farmers who are most susceptible. Therefore, it is deemed necessary to include takaful in the proposed integrative model as a mitigating factor to reduce the risk of default and burden on the farmers in the event of such losses. As a cooperative entity, the takaful will not only serve as a guaranteed element, but one which will also motivate the participants and reduce moral hazard as no member will like to be the root cause of the downfall of the project at hand. Hence, it will serve as a safety net for the farmers. As a Muslim majority country, the Gambia has yet to establish a central institution responsible for the administration of waqf, sadaqah, and related charities for socio-economic development. Hence, this study envisages the existence of these institutions and thus, their impact on agricultural productivity as a poverty alleviation mechanism.

3. Discussions

This is rather a conceptual paper, thus, descriptive and theoretical and employed a qualitative research method. Hence, the paper focuses on the literature by describing the level of poverty in the Gambia and the potentials of agricultural productivity investment through waqf, sadaqah and takaful funding structures to achieve both the National Development Plan, National Social Protection Policy, and Sustainable Development Goals (SDGs) most especially poverty and hunger elimination (SDGs 1 & 2). Therefore, the paper is based on the concept of implementing a blended model of waqf, sadaqah and takaful with a *Mudarabah* contract in the agricultural investment project. To the extent of the researcher's knowledge, there is no research or literature of such for the Gambia at the time of writing this paper.

3.1 The Components of the Proposed Integrative Model of Waqf, Sadaqah, and Takaful

This model is based on a quartette relationship between the sources of endowment (waqf and sadaqah), NAWFA (*Wakil*), Farmers, and Takaful (Islamic Insurance). Whereby the latter serving as a security element for the sustainability of the project

3.1.1 The National Women Farmers Association (NAWFA)

National Women Farmers' Association (NAWFA) is a membership-based association of 48,000 women farmers, operating in 1074 villages clustered in 74 smaller associations, which started in the late 2000s to initiate a development programme on integrated crop and livestock production, processing, and marketing. The purpose of the programme is to promote commercial agriculture among women farmers, which will encourage and support women to do farming as a business. Therefore, as an already established body that coordinates the affairs of local women farmers in the country, NAWFA will serve as an agent (*Wakil*) for the waqf institution in the execution of the project under the proposed Model.

3.1.2 The Sources of Endowment

The sources of the endowment will come from the awqaf and sadaqah donated by individuals and institutions to the waqf institution, which will include both cash and kind. The targeted endowments through the awqaf and sadaqah are but not limited to cash, agricultural lands, farm implements, tractor, threshing machines, fertilizers and manures, seeds, and pesticides. These endowments will be used to fund the local women farmers through the coordination of the National Association of Women Farmers (NAWFA).

3.1.3 The Concept of Tabarru'

"*Tabarru'*" is an Arabic word (literally referred to as a donation); it is a shared responsibility and guarantee principle which explicitly mentions that the money donated by the participants it is purely to assist fellow participants in the scheme who require assistance according to the terms agreed as long as these terms are parallel with the Shariah rulings (Zulkifli et al., 2012). In this model, "*Tabarru'*" is the voluntary donation made by the participant (The Farmer) for the spirit of cooperation and sisterhood hence, fulfilling their obligation of mutual help and joint guarantee. These funds will be used to help the farmers that experienced poor harvest due to natural disaster or climate-related issues. Therefore, participants will ripe a dual reward firstly being issued through *halal* means (≠ Insurance) and secondly the benefit of charity, as the contribution by a participant is not only meant for the contributor but other members in the takaful scheme.

3.1.4 The Mudarabah Contract

Saleem (2013, pp. 112) in his book entitled "Islamic Commercial Law", defined a *Mudarabah* as follows: Mudarabah is derived from the Arabic word *"daraba,"* which means travelling for trade. Mudarabah refers to a contract in which one of the parties provides capital (*Sahib Al-Mal*), and the other contributes expertise, labour, and entrepreneurial skill *(Mudarib)* to conduct a particular business in which both parties would share profit.

In essence, the waqf institution will ensure a *Mudarabah* contract between (NAWFA) and the Farmers at the time when the Farmers will receive the agricultural inputs from the waqf and sadaqah sources *(cash, land, farm implements, machines, seeds, fertilizers, manures, and pesticides)* via NAWFA to cultivate. The NAWFA serves as a *wakil* (agent) for the waqf institution to distribute the resources among the Farmers, and the waqf institution will determine the profit-sharing ratio between the NAWFA and Farmers in the model while levying a 10% compulsory contribution of the profit ratio allocated for the takaful.

The outcome of this paper is a proposed integrative model of waqf, sadaqah and takaful for enabling local women farmers in the Gambia to have access to agricultural inputs to cultivate and earn a living. The model is a quartette nexus between the Waqf institution, NAWFA, the Farmers, and the Takaful firm. The latter serves as a support and security system for the sustainability of the project, as elaborated above. The model will avail the women farmers in the rural Gambia to have accessibility to farmlands, farming implements, fertilizers, seeds, animal breeds, and value-added mechanisms to achieve large-scale production and marketing of the agricultural produce.

3.1.5 Description of the Integrative Model of Waqf, Sadaqah, and Takaful (refer Figure 1)

1. The Source of Funding for the project will come from the awqaf properties and will be supported by sadaqah contribution by individual and corporations as support.
2. Both financial and physical resources are being released to the *Mudaribs* (Farmers) through NAWFA, the agent (*Wakil*).
3. A *Mudarabah* contract is signed between the *Wakil* and *Mudaribs* (i.e., NAWFA and FARMERS).
4. The Resources are disbursed to the different Specialised Farmers (crop producers, vegetable farmers, poultry management and animal husbandry).
5. This is the turnover of farming activities.
6. The principal amount is refunded back to the Waqf fund (for a cyclical investment of another batch/group of farmers).
7. Profit realised from the sales of the goods is shared between the *Wakil* and *Mudaribs* and the takaful contribution on a profit-sharing ratio of 30%:60%:10%, respectively.
8. NAWFA receives 30% of the profit realised from the sales of the agricultural produce.
9. A compulsory 10% of the profit paid as a contribution to the takaful firm by farmers as a membership contribution for the unforeseen circumstance that might affect any farmer in the scheme.
10. The Farmers receive a 60% profit from their farming activity.
11. The takaful firm pools the *Tabarru'* contribution by farmers into the general takaful fund.
12. The takaful firm invests in the general takaful fund.
13. The operational cost of takaful is deducted from the fund.
14. The profits or surplus realised from the investment is shared between the participants (Farmers) contribution in the takaful scheme, and the takaful firm will be on a profit-sharing ratio of 50%:50%.
15. The takaful firm uses its 30% share of the profit to cover its administrative expense and 70% to pay off dividends to shareholders of the firm.

As mentioned above, the model is a quartette relationship of the Waqf institution, that will be responsible for the distribution of the resources and the allocation of the profit-sharing ratio between the NAWFA (*Wakil*/agent of the Waqf institution) and the Farmers as illustrated below. A 30% of the profit will go to NAWFA as an agent fee, a 10% of the profit will be paid as *Tabarru'* contribution to the takaful firm for the sustainability of the project, and the remaining 60% of the profit goes to the Farmer.

4. Conclusion

The Women farmers in the Gambia are fundamental pillars in their respective families who are actively involved in agricultural activities to provide sustenance for their loved ones. However, these women face countless gender discrimination and stigma in trying to access agricultural inputs like farmlands, implements, fertilizers, manures, seeds, etc., for cultivation. Regardless of the enormous amount of agricultural aid coming into the country from donor organisations, we are yet to see a change in the status quo or uplift these women and their families from the shackles of abject poverty. Therefore, it is only prudent to test the strength of the recently flourishing Islamic Social Financing mechanism blossoming in other OIC countries. Hence, the proposed model for local women farmers in the agricultural sector since agriculture serves as the backbone of the Gambian economy with an employability rate of over 70% of the population and contributing over 20% to GDP. The reason for the women-centred approach of this model is that the women farmers comprise 78% of the economically active population who work in agriculture compared to just 57% of the men and the women farming activities are year-round while that of the men is seasonal. These women whom must of the times are the ones involved in farming, and with little gains from the outputs, they provide food and educational expenses for their children. However, the model can also be replicated for the men too in the long run for more inclusive sustainability.

This model can ensure efficient and judicial use of resources by the Waqf institution under strict Shariah principles. NAWFA, which is the umbrella body of the national women farmers, will serve as the *Wakil* (agent) of the Waqf institution in the distribution of the resources to the farmers and monitoring of the project. The Waqf Institution will determine the distribution of the profit realised from the cultivation by the farmers. As a first-hand experience of the prevailing situations of these women and their willingness to prosper from their predicaments, that implementation of such a project can drastically change their status and pull them from the depths of poverty on to the plateau of self-sustenance and food sufficiency.

4.1 Policy Implications and Recommendations

The establishment of a fully-fledged Waqf institution and the operation of the proposed model can yield a significant result in the quest to attain the major national policy plans like the National Development Plan (2018-2021), National Social Protection Policy (2015-2025), and Sustainable Development Goals (2016-2030). As enshrined in the 2018-21 National Development Plan (NDP) strategic priority areas; "a modern, sustainable, and market-oriented agriculture and livestock sector for increased food and nutrition security, income and employment generation, poverty reduction, and economic transformation, agriculture is viewed as a prime priority sector to achieve the country's development goals" (NDP, 2017). In the year 2015, the government of the Gambia, in collaboration with the UNDP and UNICEF (Banjul offices), drafted a National Social Protection Policy with the sole aim of poverty eradication and improvement in the social welfare of the Gambian people as enshrined in the policy mission statement i.e. "The long-term vision (2015-2025) for social protection is to establish, by 2035, an inclusive, integrated and comprehensive social protection system that will effectively provide protective, preventative, promote and transformative measures to safeguard the lives of all poor and vulnerable groups in The Gambia and contribute to broader human development, greater economic productivity and inclusive growth" (UNICEF, 2015).

To extend the arguable significance of this study to the development goal of the Gambia; a consistency can be drowned from the country's strive to meet the United Nations SDGs Agenda of 2030, which are centred around eradicating poverty and ending hunger, provide good health and well-being, quality education, gender equality, clean water and sanitation, affordable and clean energy, decent work and economic growth, industry, innovation and infrastructure, reduced inequality, sustainable cities and communities, responsible consumption and production, climate action, life below water, life on land, peace, and justice strong institutions and partnership to achieve the goal. Most importantly, these above-mentioned contemporary policies are consistent with the core aims of eradicating all forms of poverty, good health and well-being, good education, and sustainable social, economic, and environmental existence. These global strategies and policies have been the core values and objectives of Islamic law (*Maqasid Shari'ah*), which dated back fourteen centuries ago. In his book *"Al-Mustasfa min 'Ilm al-Usool"* (On Legal theory of Muslim Jurisprudence), Imam Abu Hamid al-Ghazali outlined the five objectives of Islamic law (*Maqasid*), which can be traced both explicitly and implicitly from the holy Quran and the teachings and traditions of the noble Prophet Muhammad (S.A.W) as follows; (1) Protection of religion, (2) Protection of life (3) Protection of intellect, (4) Protection of progeny and (5) Protection of wealth, further illustrates in Table 1.

Table 1: Relationship between Maqasid and SDGs, NDP and NSPP

Maqasid Shariah (MS)	SDGs 2016-2030	NDP 2018-2021	NSPP 2015-2025
MS1: Protection of Religion	SDGs:4,5,10,16	NDP-SPs: 1	NSPP-PAs: All
MS2: Protection of Life	SDGs:1,2,6,7,14,15,	NDP-SPs: 1,3,4	NSPP-PAs: All
MS3: Protection of Intellect	SDGs:3,4,9,11,12	NDP-SPs:2,4,5,8	NSPP-PAs: All
MS4: Protection of Progeny	SDGs:3,17	NDP-SPs:7	NSPP-PAs: All
MS5: Protection of Wealth	SDGs:8,16,17	NDP-SPs:5,6,8	NSPP-PAs: All

Notes: NDP-SPs: National Development Plans Strategic Priorities; NSPP-PAs: National Social Protection Policy Priority Areas
*Source: (Imam Al-Ghazali: *Al-Mustasfa min 'ilm al-usul,* SDG 2030, NDP 2017 & NSPP 2015)

This study emphasises the need to establish a full-fledge Waqf institution to complement the socio-economic development projects and programs of the country amid the post-COVID-19 recovery strategy planning. However, the political will and commitment for implementation are paramount, public sensitisation and awareness campaigns to induce acceptability of Islamic Social Finance among the populace are eminent. A reform in the judiciary and educational infrastructure will be essential for this realisation to be more politically and socially sustainable.

The state has a prominent role in the successful realisation of this project since it is the mandate of the state to provide a peaceful and harmonised society by upholding social justice and transparency. The state should also promote the establishment of an Islamic financial system as an alternative for the Muslim community whose religion forbids the transactions of usury and related activities, which is the fundamental premise of conventional finance. The Islamic finance system will enable the proper distribution and redistribution of wealth through waqf, zakat, sadaqah, and other ISF tools to effectively complement the state efforts in alleviating poverty in the country. There should be a reform in the educational sector to cater for the training of people in Islamic finance and Islamic wealth management to fill the gap in human resources.

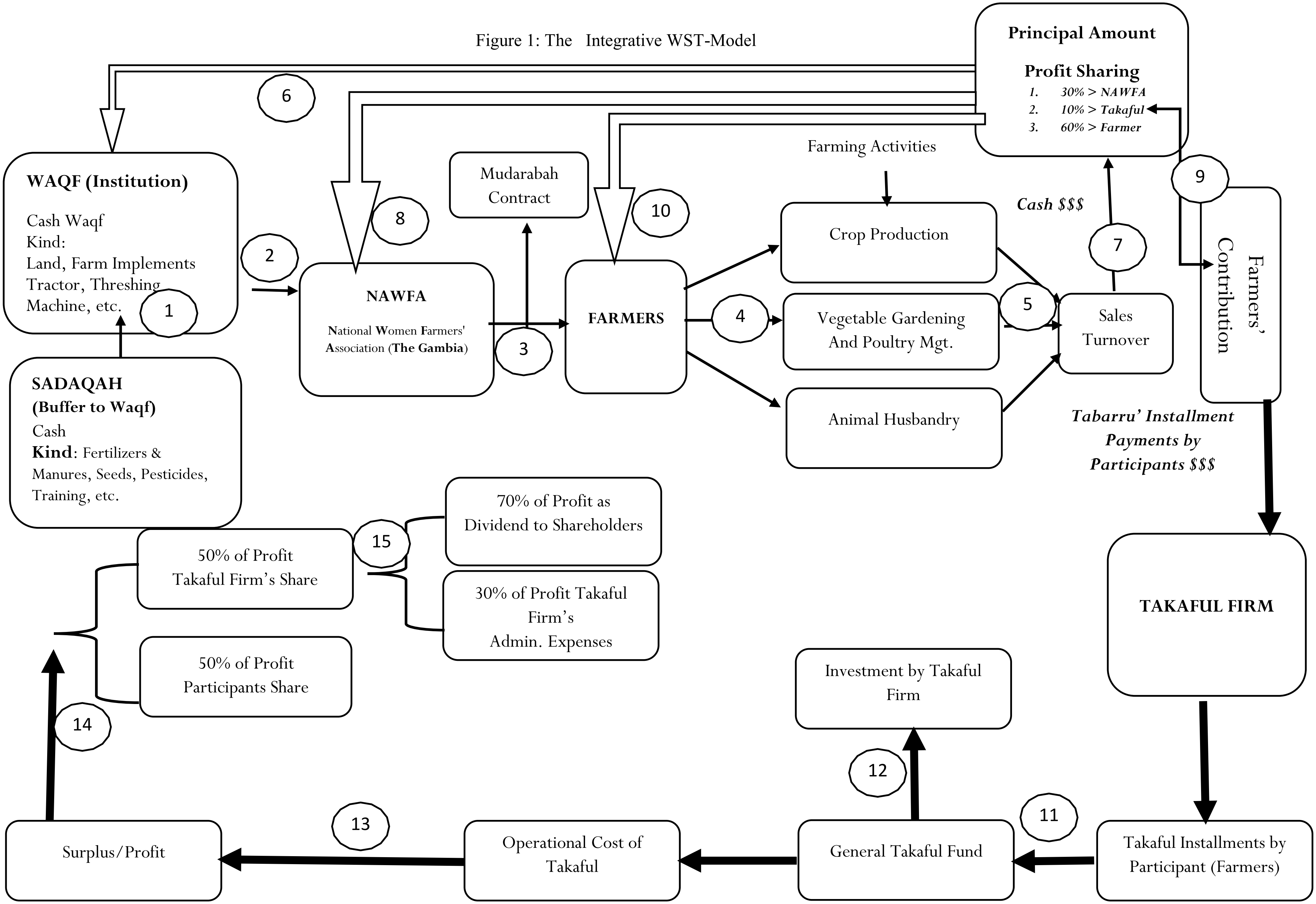
Thus, the study recommends the provision of an alternative financial system (Islamic) in The Gambia by the Central Bank with a Shariah regulatory body (Islamic Finance Jurisprudence experts) to achieve financial inclusiveness as a significant number of the population prefer not to bank with the conventional banks as a result of usury and manner of operations which are against their religion and belief. Hence, with such a financial system and an established national Waqf (Endowment) institution that can harness resources of the country and channel them to affect a positive impact on agricultural productivity as a poverty alleviation mechanism. Therefore, the idle land and other related assets can be put to useful activity if such institutions are available.

This study will serve as a roadmap and springboard for policymakers to better channel the state resources in the most productive areas of the country's economy, which is arguably agriculture, and it has the potential to achieve more than half of the above-mentioned sustainable national goals because of its multiplier effect on the lives of Gambians.

4.2 Future Research Areas

This study proposed an integrative waqf model to provide funding for women farmers in rural Gambia. Hence, a future study can also look into the awareness and readiness of the Gambian populace to accept the Islamic financial system. It will be interesting for a future study to assess the availability of waqf properties in the Gambia to measure the level of potential impact on national development. All this may be futile if the current legal system cannot accommodate the establishment of a national waqf institute. Therefore, a study reflecting the possibility of how the current legal system can afford the establishment of a national waqf institute in the Gambia is imperative.

Figure 1: The Integrative WST-Model



Source: Author own

Acknowledgement
The author would like to express his appreciation to Asst. Professor Dr. Mahomed Ziyaad of INCEIF for his immense contribution to the success of this paper and the University of the Gambia Management for their unflinching support.

The paper has been presented at the International Conference on Islamic Social Finance: Pandemic Crisis and Possible Solutions (Online) on 29th – 30th September 2020, organized by the IIUM Institute of Islamic Banking and Finance. The author thanks the reviewers and the Journal Editor for the constructive comments for further improvement of the paper.

References

BadibangaT., & Ulimwengu, J. (2020). Optimal investment for agricultural growth and poverty reduction in the democratic republic of congo a two-sector economic growth model. *Applied Economics*, *52*(2), 135-155.

Baqutayan, S. M., Ariffin, A. S., Mohsin, M. I., & Mahdzir, A. M. (2018, July). Waqf between the past and present. *Mediterranean Journal of Social Sciences, 9*(4), 149-155.

Bensaid, B., & Grine, F. (2013). Ethico-spiritual dimensions of charity: an Islamic perspective. *Middle-East Journal of Scientific Research 13(Special Issue of Economics)*, 65-77.

Byerlee, D., Diao, X., & Jackson, C. (2005). Agriculture, rural, development and pro-poor growth: country experiences in the post-reform era. Washington, DC: *The World Bank: Agriculture and Rural Development Discussion Paper 21*.

Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation (COMCEC) (2019). *Poverty Outlook.* Ankara: COMCEC.

Datt, G., & Ravallion, M. (2007, November 23). Farm productivity and rural poverty in India. *The Journal of Development Studies, 34*(4), pp. 62-85.

Dhahri, S., & Omri, A. (2020). Foreign capital towards SDGs 1 & 2—Ending Poverty and hunger: the role of agricultural production. *Structural Change and Economic Dynamics*, *53*, 208–221.

Elasrag, H. (2017). *Towards a new role of the institution of waqf.* South Corolina, US: CreateSpace Independent Publishing Platform.

FAO, F. A. (2019). Country Gender Assessment Series: National gender profile of agriculture and rural livelihoods. *The Gambia. Banjul: Food and Agriculture Organisation of the United Nation.*

Htaya, S. N., Salmanb, S. A., & Ilyas, S. M. (2013). Integrating zakat, waqf and sadaqah: myint myat phu zin clinic model in Myanmar. *Tazkia Islamic Finance and Business Review, 8*(2), 170-186.

Irz, X., Lin, L., Thirtle, C., & Wiggins, S. (2001, December 16). Agricultural productivity growth and poverty alleviation. *Development Policy Review, 19*(4), 449-466.

Islamic Financial Services Board (IFSB). (2009). *Guiding Principle on Governance For TAKĀFUL (Islamic Insurance) Undertakings.* Kuala Lumpur: IFSB.

Islamic Financial Services Board. (2019). *Islamic Financial Services Industry Stability Report.* Kuala Lumpur: Islamic Financial Services Board.

Kahf, M. (1998). Financing the development of awqaf property. Seminar on Development of Awqaf. Kuala Lumpur: Islamic Research and Training Institute (IRTI).

Kahf, M. (2015). *"Waqf: a quick overview".* Retrieved January 23, 2020, from http://monzer.kahf.com/papers/english/ WAQF_A_QUICK_OVERVIEW.pdf

Lahsasna, A. (2010). *Understanding Shariah financial planning.* Kuala Lumpur: Malaysian Financial Planning Council.

Magda, M. I., Dafterdar, H., Cizakca, M., Alhabshi, S. O., Razak, S. H., Sadr, S. K.,& Obaidullah, M. (2016). *Financing the development of old waqf properties: classical principles and innovative practices around the world.* US: Palgrave Macmillan.

Mellor, J. W. (1999). Faster more equitable growth - the relation between growth in agriculture and poverty reductio. Agricultural Policy Development Project Research Report No. 4. *Washington, DC: United States Agency for International Development.*

Muhammad, A.I.S.D. (2015). *The book of endowment (kitab al-waqf)* (1st ed.). (N. M. Lock, Trans.) Kuala Lumpur, Malaysia: Islamic Banking & Finance Institute Malaysia (IBFIM).

Nasiri, A., Noori, A., & Salleh, M. C. (2019, July). Acceptance and practices of cash waqf among university's students. *International Journal of Academic Research in Accounting, Finance and Management Sciences, 9*(3), pp. 38-48.

NDP. (2017). *The Gambia National Development Plan 2018-2021.* The Ministry of Finance and Economic Affairs, Department of Planning. Banjul: The Gambia Government.

Saleem, M. Y. (2013). *Islamic commercial law.* Singapore: John Wiley & Sons Singapore Pte. Ltd.

Schneider, K., & Gugerty, M. K. (2011). Agricultural productivity and poverty reduction: linkages and pathways. *The Evans School Review, 1*(1), 56-74.

Thirtle, C., Lin, L., & Piesse, J. (2003). The impact of research-led agricultural productivity growth on poverty reduction in Africa, Asia and Latin America. *World Development, 31*(12), 1959–1975.

Thorbecke, E., & Jung, H.-S. (1996). A multiplier decomposition method to analyze poverty alleviation. *Journal of Development Economics, 48*(2), 279-300.

Timmer, C. P. (1995, October). Getting agriculture moving: do markets provide the right signals? *ScienceDirect Elsevier: Food Policy, 20*(5), 455-472.

United Nations Development Programme (UNDP). (2020). Sustainable development goals. Retrieved February 5, 2020 from, https://www.undp.org/content/undp/en/home/sustainable-development-goals/goal-1-no-poverty.html.

UNICEF. (2015). *The Gambia National Social Protection Policy.* Ministry Of Health. Banjul: UNICEF Gambia.

World Food Programme (WFP). (2019). The Gambia country strategic plan (2019-2021). Retrieved from, https://www.wfp.org/operations/gm02-gambia-country-strategic-plan-2019-2021

Zulkifli, A. M., Rahman, B. H., Yassin, N., & Ramly, J. (2012). *Basic takaful practices: entry level for practitioners.* Kuala Lumpur, Malaysia: Islamic Banking & Finance Institute Malaysia (IBFIM).

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 13-25
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Exploring the Challenges of the Historical Development of Islamic Banking System in Afghanistan Using Document Analysis

Khatera Naseri[a*], Ashurov Sharofiddin[b]

[a]*Banking and Finance Department, Economics Faculty, Herat University, Afghanistan*
[b]*Institute of Islamic Banking and Finance, International Islamic University Malaysia*

[*] *Corresponding author: khateranasiri@gmail.com*

Abstract

The banking system of Afghanistan has experienced various conditions since the establishment of the first bank in 1933 and could not develop enough due to the civil war. This study investigates the historical development of the banking sector especially Islamic banking in Afghanistan. In addition to civil wars, Afghanistan's banking system has faced many challenges in terms of modernization, the low number of depositors and borrowers, regulations, and so on. It is found through qualitative research approach using documentary analysis that there was significant progress in modernizing the banking sector in Afghanistan with the help of international donors since 2001. Afghanistan has a dual banking sector and there is a full-fledged Islamic bank, the Islamic Bank of Afghanistan (IBA), and some banks with Islamic banking windows. However, according to findings the number of banks decreased compared to 2018 from 14 banks to 12 banks in 2020. The implication of this study is to provide information for the policymakers and Islamic banking institutions in Afghanistan to learn from these challenges and to improve the Islamic banking system in the country. Moreover, this study will fulfill the literature gap regarding the Islamic banking system in Afghanistan.

Keywords: Banking system, Islamic banking, Afghanistan

1. Introduction

The Afghan banking system started with the establishment of the Bank-e-Millie Afghan (National Bank of Afghanistan) in 1933, which handled Afghanistan's state banking affairs before the establishment of the Da Afghanistan Bank (Central Bank of Afghanistan). After the establishment of the Da Afghanistan Bank (DAB) in 1940, the state-owned banking responsibilities were transferred from Bank-e-Millie (BMA) to DAB (Da Afghanistan Bank, 2019a). The development of the banking system continued until 1975 with the establishment of four other banks such as Agricultural Development Bank (1954), Pashtany Tejaraty Bank (1955), Industrial Development Bank (1973) and Export Promotion Bank (1975) (Pernia et al., 2005). Banks have not been able to make significant progress over the past three decades due to political unrest. An informal system was created in addition to the banking system, which engaged in banking transactions such as buying and selling currency and offering short-term loans. This was the golden age of the informal money transfer (*Hawala* system) (Taqipor, 2017).

During the Taliban regime from September 1996 until November 2001, the commercial banking operations has stopped, because banks did not allow paying or charging interest (*riba*) according to Islamic law and consequently, banks stopped all lending activities (Katzman and Thomas, 2017; Pernia et al., 2005). The banking system was re-established and revitalized in December 2002, with international support and made significant progress. Besides, banking regulations, especially on loans, were issued in 2003 and early 2004. This recovery continued until 2010 when Kabul Bank, one of the largest commercial banks (CBs), faced

Article history:
Received 13 May 2020
Revised 22 September 2020
Accepted 18 October 2020

bankruptcy. The stability of the financial system was threatened by the crisis. The main reasons for the bankruptcy were corruption, solvency, incapability, and political interactions (Taqipor, 2017).

According to the Afghanistan Central Bank website online data, currently there are 12 licensed banks, of which three are state-owned, seven are private CBs, and two are foreign banks. However, Islamic banking was introduced between 2008 and 2009, the first full-fledged Islamic bank (FFIB), IBA was launched only in April 2018 (Da Afghanistan Bank, 2019b).

Promoting Islamic banking is one of the DAB commitments by introducing a legal and regulatory framework for Islamic banks. Consequently, to control and regulate Islamic banking activities, DAB has issued specific Islamic banking regulations which include many categories such as, guidelines, Islamic banking regulations, product descriptions, Shariah parameters, and so forth (Da Afghanistan Bank, 2019c). So far, DAB has licensed several Islamic banking windows of conventional banks offering Islamic banking products and services. However, the existence of Islamic banking windows is not enough just to meet the needs of the country (Da Afghanistan Bank, 2018b).

Nowadays, CBs offer a variety of services such as opening various bank accounts, lending, money transfers, especially using Swift and Western Union networks, issuing various bank cards including Visa card and Master card, issuing bank guarantees and letter of credit for businesses, launched e-banking services such as mobile banking, internet banking, and ATMs.

2. Literature Review

Afghanistan banking law has some definitions for bank, Islamic bank, and conventional bank. The term "Bank" means "a legal entity engaging in the business of receiving money deposits or other repayable funds from the public and making credits for its benefit, and includes Islamic bank and conventional bank," while "Islamic Bank" means "a bank which operates following Islamic Shariah*," and* "Conventional Bank" means "a bank operating under traditional banking practices" (Da Afghanistan Bank, 2015).

2.1 The Differences between Islamic Banking and Conventional Banking

There are some differences between the practice of Islamic banking and conventional banking and the details of a comparison between them are shown in Table 1 below.

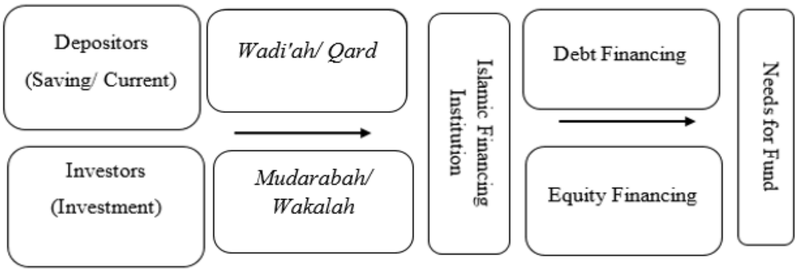
Table 1: Compression between Islamic and Conventional Banking

Islamic Banking	Conventional Banking
Free from *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling)	No prohibition of *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling)
Based on the Shariah	Based on man-made laws and principles.
Financing is based on Shariah-compliant contracts such as *Murabaha*, *Mudarabah*	Financing is based on a lending contract
Different kinds of relationships between the bank and customer such as buyer/seller or lessor/lessee	Only a creditor and debtor relationship between the bank and customer
Making profit out of Shariah-compliant contracts	Making a profit from the interest charged in the loan/lending

Source: Hassan et al. (2016)

According to the nature of Shariah contracts, the relationship between the customer and the bank is differentiated in Islamic banking. For instance, in the transaction based on trading, the relationship can be as a buyer and a seller; in leasing, it can be as lessor or lessee and in an investment, the relationship is as partners and the bank will gain profit that is derived from Shariah-compliant contracts (ISRA, 2016). An Islamic banking model is illustrated in the Figure 1 below.

Figure 1: Islamic Financial Institution



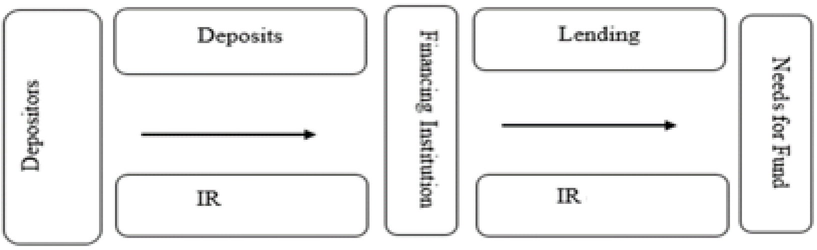
Source: Hassan et al. (2016)

Based on Figure 1, as debt-based or profit-sharing as equity financing, the deposit contract can be in the form of:

- *Wadi'ah/ Qard*: The customers deposit their money for safekeeping purposes, while the bank as an obligor is obliged to pay back the amount whenever the customer asks for a return.
- *Mudarabah/Wakalah*: Bank can act as an entrepreneur and invest the money on behalf of the investors.

However, in conventional banking, the bank and customer relationship is based on the principle of lending and borrowing. In this model, the bank will pay interest for the deposits and take interest from loans and will make a profit from the margin between the price of deposits and loans. The conventional banking model is illustrated in Figure 2 below.

Figure 2: Conventional Banking Model



Source: Hassan et al. (2016)

According to Figure 2, the relationship between the customer and the bank is based on the loan contract. Depositors deposit their money in the bank and the bank, as the borrower, promises to repay the principal on maturity with a certain amount of interest, for example, 4% to the customer periodically or as prearranged. The bank lends depositors' deposits to other customers who need capital, and borrowers pay the principal at an interest rate of, for example, 7% to the bank. The difference between the interest rate received by the bank at 7% and the interest rate paid at 4% constitutes the bank's profit (3%).

2.2 Salient Feature of Islamic Banking

Islamic banking has its salient features that differs from those of conventional banking. These features include *riba*-free banking, *gharar*-free, profit and loss sharing, money does not create money, Shariah-compliant contracts as clarified in the sub-sections below.

2.2.1 Riba-Free

Riba is an Arabic word that indicates an increase, addition, or extra (Bayindir and Ustaoglu, 2018). For a person who wants to raise money, it is recommended for him/her to enter into a business or partnership agreement. Claiming an extra amount of money over money is a kind of *riba*, which is the Islamic term for usury, as defined in Islamic teachings (Siddiqi, 2019). *Riba* is forbidden in the *Quran* in four stages. The first stage is in *surah al-Rum*, verse 39, in which *riba* is compared to zakat and charity, and in which zakat and charity are praised, not *riba*. The second stage is in *surah an-Nisa* verses 160-161, which illustrate the practice of *riba* by the Jews and declares it as iniquity. The third stage is the prohibition of practicing and charging double and multiple *riba* in *surah Ale- Imran* verse 130. The fourth stage is in *surah al-Baqarah* verses 275-281 which is forbidden all types of *rib*a, forbidding charging any extra amount of money over money.

2.2.2 Gharar Free

Gharar has a wide range of negative concepts, including uncertainty, risk, deception, ignorance, hazard, etc. The existence of *gharar* may deprive the contracting parties from equal bargaining power. Hence, it causes the inability to make informed decisions as they may not be properly understand the characteristics or consequences of the contract. *Gharar* can be divided into types of major and excessive (*gharar fahish*) and minor and tolerable (*gharar yasir*). Excessive *gharar* affects the validity of the contract, and it will make it void (*batil*) or voidable (*fasid*), which depends on the degree of *gharar*. While the minor or tolerable *gharar* will not affect the contract validity (Engku Ali, 2010). The prohibition of *gharar* could be deduced from *surah an-Nisa verse* 29.

"O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful".

2.2.3 Profit and Loss Sharing

The prohibition of *riba* is one of the most important differences between Islamic banking and conventional banking. The prohibition of usury in Islam raises the question that what can be replaced for it. The profit and loss sharing (PLS) can be a good replacement for usury (Efendić et al., 2017). While the existence of *Murabaha, Musharakah,* and *Mudarabah* contracts can be other important contracts in Islamic finance. Some profit and loss sharing contracts were also common in pre-Islamic times and at the time of the emergence of Islam, for instance, *Mudarabah* and *Musharaka*h. At the time of the emergence of Islam, the Prophet Muhammad S.A.W. himself acted as agent (*mudarib*) for his wife Khadija. However, his second successor Umar ibn Khattab invested orphan money with the merchants involved in the trade between Medina and Iraq. It is described that banks and borrowers should share the risk and profit in any business transaction (Hassan and Lewis, 2007). Therefore, we can see the differences in conventional banking where the customers are liable for any losses, because of no profit and loss sharing principle; the customers are liable to pay the principal and interest regardless of the success or failure of his business (Ahmed, 2018).

2.2.4 Money Does Not Create Money

Money is a medium that defines the value of material things. Hence, the fiat money by itself has no value and it is only a medium for exchange. A government decree determines its value, and the creditors must accept the fiat money to settle the debt, and referred to as "legal tender - refusal" to accept payment is considered illegal. Legal tender such as paper notes and coins is a means of payment recognized by a valid legal system to settle a financial obligation (Abdullah, 2018, p. 18). Thus, just because money is lent to others or kept in a bank, it should not be allowed to generate or give rise to more money. In the Islamic financial system, money has no return without legal conversion into real capital (Abdullah, 2018, p.18). To avoid any unjust enrichment, Islam requires collaboration between capital and effort to obtain some profit from the investment. There is a Hadith from the Prophet S.A.W. that says *al -ghurm bil ghunm* (no reward without risk), which proves that any return without taking any risk is not permissible. Therefore, the practice of conventional banks, giving loans, and charging interest show that money earning is without taking any risks. The customers who deposit their money in such banks should not earn any fixed return from their deposits (Hassan et al., 2016).

2.2.5 Shariah Compliant Contracts

Shariah has a significant impact on every aspect of Muslim culture. Some scholars have stated to some extent that Islam is very comprehensive, as it influenced the business with its particular provisions (Cerimagic, 2010). According to *Surah al – Baqarah*, 2:275, it is clear that Allah permits trade and forbids *riba*. However, it should be noted that trade in this verse does not include only selling and buying, and based on this verse the wisdom is practicing economic justice by mankind. Islam does not accept the contract of the interest-based loan nor is it considered a fair business contract. If a customer, with a savings account, expects a fixed return from it, it is not allowed because Islamic banks do not deal with the contract of debt. There are some contracts such as *al – Wadi'ah* and *Mudarabah,* that are used for replacing the contract of debt in conventional deposits. Islam encourages people to earn a return by taking a risk in their business ventures. Hence, customers are aware that based on Islamic banking and finance (IBF) services they may lose money without any fixed interest rate. While taking more risk, they can expect a higher return in contracts such as in the *Mudarabah* contract (Hassan et al., 2016).

Riba contract is described as being non Shariah-compliant contract. The term "Shariah" is defined as "the path to the watering place" (Siddiqi, 2019, p.24-25). In technical and legal usage, however, Shariah refers to the commands, prohibitions, guidance, and principles derived from the primary sources of Islam, the Quran and Sunnah. Hence, A product that is Shariah compliant indicates a product that is acceptable from an Islamic point of view (Siddiqi, 2019).

3. Methodology

This sudy uses a qualitative research method based on document analysis and various sources such as publications, and websites of banks (state-owned banks, foreign banks and private banks), websites of international organizations, on-line databases, policies, manuals, books, articles, working papers, and periodic reports were used to provide information on the challenges of the historical development of the Islamic banking system in Afghanistan.

Document analysis refers to evaluating and reviewing documents to extract their meaning, gain understanding, and develop empirical knowledge. Documents that may be used for analyzing can include agendas, meeting minutes and attendance registers, background papers, books, printed outlines of an event program, diaries, and journals, newspapers, and so forth. Basically in historical research, a prior study can be the only way to get resources (Abdul-Baki and Uthman, 2017). Kamla and Rammal (2013) in their study on social reporting by Islamic banks used content analysis as well through using the web sites and 19 annual reports of banks, tried to obtain disclosure concepts, and assign them to appropriate categories. Abdul-Baki and Uthman (2017) and Sutrisno and Haron (2020) also used content analysis with data collected from previous studies. Following the previous literature, this study therefore employed document-based qualitative research to study the challenges of the historical development of Islamic banking system in Afghanistan.

4. Findings and Discussion

4.1 Financial Sector of Afghanistan

Afghanistan is faced with many economic challenges. The most considerable of these is the reconstruction and reform of its institutions and the placement of its financing in a sustainable way (Akhtar et al., 2009). The banking sector in Afghanistan has seen a significant reconstructions since the collapse of the Taliban regime in 2001 (Turner, 2014). With the beginning of 2002, Afghanistan remained with a banking system that was physically demolished, technically outdated, and operationally inoperable. Six CBs owned by the government remained in poorly conditioned buildings. They did not have the basic infrastructure to support any kind of business, and the country was often financially bankrupt. DAB under the Taliban regime was abandoned under the weak legal and regulatory framework under the Money and Banking law of 1994. In addition, for serious operational weaknesses, the law also imposed barriers and was largely inconsistent with best international practices. There was no function of the monetary policy framework and it was not possible to provide monetary and fiscal stability. Besides, high inflation with multiple versions of the same currency destroyed the value and credibility of the currency (Pernia et al., 2005).

Pernia et al. (2005) also went on to comment on the state of Afghanistan post-Taliban. According to them, because of the absence of regulation caused the central bank failed to oversee the operations of six state-owned commercial and development banks. They did not have the skills and training needed to run modern financial institutions. From an accounting perspective, banks continued to rely on handwritten books and the accounting records had not been prepared for many years. These factors reduced public confidence in the banking system. The people did not use banks for placement of deposits or other transactions, which reduced the base of bank resources for lending. Except for a few part-directed lending deals and a special lending program in one of the cities, banks had suspended all lending operations. They were left with loan portfolios that in most cases were created more than 15 years ago.

Charap and Pavlovic (2009) provided some interesting insights into the financial situation in Afghanistan. The absence of confidence on the banking system, uncertainty, and the problems faced by the people and businesspersons led to a relatively unique *Hawala* system, which was very effective and informal, based on the trust and credibility of the participants. The *Hawala* system substituted CBs, including deposits, credits, and foreign exchange operations.

However, there were numerous failings (weak management, poor practices, and banking law violations), but these banks still managed to be profitable. Since 2005, the majority of the banks have provided essential services and their operations have been strictly limited because of the lack of sufficient laws and regulations (including bankruptcy, contract law, and mortgage). Some issues such as uncertainties and security restricted the performance of CBs in remote areas. In March 2008, the Afghan financial system included 15 licensed CBs that had 183 branches in 20 provinces, 332 foreign exchange dealers and 100 licensed money service providers.

Table 2: Afghanistan Banking Sector Data

Afghanistan Banking Sector Data (In millions of U.S. dollars)					
Year	2004	2005	2006	2007	2008
Total Assets	261	386	614	1083	1674
Cash and Bank Balances	139	212	259	431	578
Loans and Advances	18	58	162	439	805
Total Deposits	60	182	394	812	1278

Source: Charap and Pavlovic (2009)

The development of CBs' balance sheets during 2004-2008 can be seen in Table 2 which shows a sharp rise in bank deposits and also in loan provisions and advances. In terms of deposits, local private sector bank growth improved faster than both state-owned and foreign-owned banks .

4.2 The Central Bank after 2001

In 2001, DAB faced immediate problems, including its legal independence problems; inadequate efforts to improve international and domestic payment systems; and a number of the obstacles in its efforts to build domestic and technological capacity. All these issues significantly slowed the pace of reforms of the 2002 and 2003 innovations (mainly designed to solve the urgent problems regarding payment systems) and failing to achieve the initial goals of the reformers. In 2003, DAB was still far from meeting the basic criteria of modern central banking. Many comprehensive reforms were needed (Pernia et al. 2005).

With the assistance of international and bilateral organizations, the central bank's rebuilding and modernization began in mid 2002, despite the challenges faced, with the following initiatives:

- The new central bank law was in place, which was the autonomy of the central bank guarantees.
- There was a new commercial banking law that required banks to perform banking operations and withdraw from the financial sector.
- Following the successful release of a new currency, a major monetary policy would eventually emerge.
- A new banking-monitoring agency was underway and started inspections on the state banks.
- The SWIFT central bank connection was feasible - one-third of the central bank branches were connected electronically to domestic payments.
- The operational capacity of the central bank has improved significantly (Pernia et al. 2005).

Today, the central bank of Afghanistan has made great strides, including the creation of the "dab.gov.af" website with the publication of rich resources and information in three languages: Dari, Pashto, and English; including reports, banking, and financial laws and regulations, policies, manuals, etc. The central bank of Afghanistan has issued the Islamic banking regulations and is trying to expand Islamic banking by publishing various guidelines, policies, manuals, and procedures for them.

4.3 Licensed Financial Institutions

One of the key tasks of the central bank of Afghanistan is licensing and regulating banks, forex dealers, and money service providers (MSPs). Afghanistan's financial system consists of banks and non-bank financial institutions. Also, other than the banks, there are forex dealers, financial service providers, electronic money institutions, and forex exchange companies, as part of non-bank financial institutions. This is one of DAB's responsibilities for licensing and supervising non-bank financial institutions and banks (Da Afghanistan Bank, 2019b).

Table 3 shows the list of licensed banking institutions in Afghanistan, with 12 banks. From those banks, one of them is a full-fledged Islamic bank, which is the IBA, four conventional banks, and seven conventional banks with Islamic banking windows.

Table 3: Licensed Financial Institutions

No	Name	Type	License Date	Type of Bank
1	Bank-e-Millie Afghan	State-Owned Bank	Relicensed 26 July 2004	Islamic Banking Window
2	Pashtany Bank	State-Owned Bank	Relicensed 26 June 2004	Conventional Banking
3	New Kabul Bank	State-Owned Bank	18 April 2011	Islamic Banking Window
4	Azizi Bank	Private Bank	June 13, 2006	Conventional Banking
5	Afghanistan International Bank	Private Bank	March 22, 2004	Islamic Banking Window
6	Islamic Bank of Afghanistan	Private Bank	18 March 2009	Full-Fledged Islamic Bank
7	Maiwand Bank	Private Bank	31 December 2008	Islamic Banking Window
8	Afghan United Bank	Private Bank	4 October 2007	Islamic Banking Window
9	Ghazanfar Bank	Private Bank	1 March 2009	Islamic Banking Window
10	The First MicroFinance Bank	Private Bank	18.March.2004	Conventional Banking
11	National Bank of Pakistan	Branch of Foreign Bank	Permitted 1st October 2003	Islamic Banking Window
12	Bank Alfalah Ltd	Branch of Foreign Bank	21 May 2005	Conventional Banking

Source: Da Afghanistan Bank (2019b)

According to Table 4, as at end of 2018 there were around 14 banks (state owned, private, and foreign bank branches in Afghanistan). While in 2019 the number of banks decreased to only 12 banks. Additionally, the number of depositors increased from 3,396,629 in 2017 to 3,837,216 in 2019 and borrowers from 64,103 in 2017 to 67,376 in 2019, indicating an encouraging uptrend including some increases in depositing and lending activities.

Table 4: Quarterly Financial Sector Financial Statistics

Quarterly Financial Sector Financial Statistics					
	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q3, 2019
No. of banks	15	15	15	14	13
State-owned banks	3	3	3	3	3
Private CBs	9	9	9	8	8
Branches of foreign banks	3	3	3	3	2
No. of branches	416	416	416	414	410
No. of branches: State-owned banks	130	130	130	130	130
No. of branches: Private CBs	281	281	281	279	276
No. of branches: Branches of foreign banks	5	5	5	5	4
No. of depositors	3,396,629	3,422,670	3,515,377	3,589,972	3,837,216
No. of borrowers	64,103	66,427	68,545	71,165	67,376

No. Of ATMs	248	249	68,545	332	356
No. of Credit Cards	1,516	1,742	1,957	2,016	1333
No. of Debit Cards	335,274	370,288	415,399	455,376	643734
	Amounts in Million AFN				
Total Assets	316,137	295,089	307,650	309,157	298,276
Total Gross Loans	41,801	38,163	42,122	43,205	42,373
Total deposits	270,256	250,230	263,305	264,924	253,919
Non-bank					
No. Of MSPs	1108	1,102	1,155	1,289	1561
No. Of FXDs	1748	1,666	1,647	1,697	1639

Source: Da Afghanistan Bank (2018a, 2019d)

4.4 Islamic Banking

Although Islamic banking services began in mid 2008 and 2009, IBA is the first fullfledged Islamic bank in Afghanistan.The IBA (formerly Bakhter Bank) serves as a merged banking organization under the Afghan Banking Law and the license of the DAB. Since 2009, the IBA 100% owned by Azizi bank. Currently, IBA has established 62 branches throughout the country with more than 800 trained and skilled employees. DAB granted in-principle approval for the Islamic banking business for IBA in January 2016. After that, IBA started the process of procurement of banking system for Islamic banking. When the conversion process was completed the DAB granted the full-fledged Islamic banking license to IBA in April 2018. Nowadays IBA offers some Islamic banking services and products such as *Murabaha, Ijarah, Musharakah, Istisna and Salam.* IBA provides many facilities for its customers such as the Guarantee (*Kafalah*, Surety) Facility (Performance Guarantees, Advance Payment Guarantees, Bid Guarantees, Guarantee for Release of Retention Money, Credit Sale Guarantees), Opening Accounts (*Qard-ul-Hassan* Current Account, *Mudarabah* Saving Account, *Mudarabah* Fixed Term Account), products such as *Murabaha* (*Murabaha* to Purchase Order, Spot *Murabaha,* Deferred Payment *Murabaha*, LC *Murabaha*), *Ijarah*, *Musharakah*, *Istisna*, *Salam* and treasury (*Shariah* Compliant Money Market Services, *Sukuk* Portfolio Management, *Shariah* Compliant Foreign Exchange Services) ("Islamic Bank of Afghanistan (IBA)," 2019). In the following section, will discuss some banks having Islamic banking windows.

4.4.1 Bank-e-Millie Afghan (BMA)

BMA is the first financial institution of Afghanistan established in 1933, which was a public-private partnership. It was 72 % share held by a private sector. BMA introduced formal banking services to the people and government as the first bank in Afghanistan. Later in 1976, it was completely nationalized by the government of Afghanistan. BMA has 15 city branches in Kabul and 21 branches in other provinces with equity investments in the United States of America and England. It is offering Islamic banking products as well such as Islamic current deposit, *Mudarabah* savings deposit, *Mudarabah* fixed deposit, *Musharakah,* and *Istisna* and it has Home Financing, Car Financing, Trade Financing as well that is based on *Murabahah* contract ("Bank-e-Millie Afghan (BMA)," 2019).

4.4.2 New Kabul Bank (NKB)

NKB has launched the Islamic banking window that provides Shariah-compliant products and services in mid-2010 and within one year, the Islamic banking window business has more than 70 branches throughout Afghanistan. It includes Personal Banking (deposit and financing), Business Banking (deposit and financing), and Cards (Islamic cash card and Islamic Debit Card (Master Card)) (New Kabul Bank, 2019).

4.4.3 Afghanistan International Bank (AIB)

AIB was established in 2004 and now has 35 branches and two cash outlets. It has Islamic banking windows that offer personal banking (*Qard* current account, *Mudarabah* savings account, *Mudarabah* term investment deposit), business banking (Qard current account, *Murabaha* financing), and Islamic Shariah compliance certificates (Credit card certificate, Debit card certificate, *Haj,* and *Umrah* prepaid card certificate, current account certificate, savings account certificate, term deposit investment account certificate, corporate financing certificate, vehicle financing certificate) (Afghanistan International Bank (AIB), 2019).

4.4.4 Maiwand Bank (MB)

This bank was established and has begun the banking operations from January 2009. Now it has 24 branches and 18 extension counters in different parts of the country. Further licenses for the opening of more branches are under process. The bank has its presence in 17 provinces and intends to mark its presence in all provinces. Mawaind Bank considers Islamic banking as one of its services and it has an independent functional department for it. However, no extra information can be found about Islamic banking services and products from its website (Maiwand Bank, 2019).

4.4.5 Afghan United Bank (AUB)

AUB commenced its operations in 2007 and received the license for the Islamic banking window from DAB in April 2008. AUB has 26 branches with two full-fledged Islamic banking windows. It provides Islamic Shariah-compliant banking services and products based on Shariah rules and principles. In the Global Finance world's best Islamic financial institutions, AUB has been awarded as "Best Islamic Financial Institution" for two consecutive years 2014 and 2015. This bank has two categories of facilities for individuals and businesses. The depository accounts for individuals include Islamic current account, Islamic savings account, special Child Saver account, and Islamic time deposit account. The business facilities are divided into investment facilities such as *Murabaha* and *Ijarah*/Lease, non – funded facilities such as Islamic bank guarantees and Islamic letter of credit (LC) (Afghan United Bank (AUB), 2019).

4.4.6 Ghazanfar Bank (GB)

Ghazanfar Bank was licensed as a full-fledged CB and begun its operations in March 2009. The shareholders of the bank belongs to a business group in Afghanistan that do business activities such as import and distribution of petroleum/gas and other various important industrial sectors. Ghazanfar Bank is offering Islamic and conventional financial services. Its Islamic banking facilities are deposit products such as *Al Wadi'ah* current account, *Mudarabah* fixed deposit account, *Mudarabah* saving account, and Shariah credit facilities such as *Murabaha, Musharakah.* Now it has around 14 branches of Islamic banking in the country (Ghazanfar Bank, 2019).

4.4.7 National Bank of Pakistan (NBP)

NBP as one of the foreign banks offering some Islamic banking products and services in various deposit schemes and IBF facilities such as *Aitemaad Ijarah, Aitemaad Murabaha*, *Aitemaad Diminishing Musharakah*, *Aitemaad Salam*, *Aitemaad Istisna*, *Aitemaad Tijarat* (National Bank of Pakistan, 2019).

5. Challenges and Problems of Islamic Banking

Islamic banking, especially the nascent Islamic banking sector in Afghanistan, is facing some challenges and problems. For banks, the lack of liquidity is considered as one of the main reasons for failure. Liquidity term refers to the amount of capital that exist for expenses and investment, while the banks' liquidity is their ability to meet credit claims related to maturities and liabilities. Liquidity risk is the lack of liquidity needs by banks for their debts (İncekara and Çetinkaya, 2019). Khan and Bhatti (2008) noted, Islamic banks have about 40% more liquidity than conventional banks due to acute shortage in long-term Shariah-compliant investment tools and 95% of their funds are committed to short-term instruments such as *Ijarah*, *Murabaha*, and *Musharakah*. Establishing a secondary market for Islamic bonds, equities, government securities, mutual funds, and other instruments can be solutions to this problem. Even a low percentage of Afghans (10%) deal with banks, the Afghanistan banking sector, has high liquidity, it has failed to play a considerable role in economic and financial development (Rostom, 2018). It means it failed to properly allocate the deposits in the investment side of the balance sheet.

In developing the modern financial sector, there is a serious need for highly educated specialists in the fields of finance, economics, IT, and accounting. Besides, for a prudent and useful regulating and supervising of the financial sector it needs trained specialists (Askari et al., 2011). There is a severe shortage of human resources in Islamic financial institutions. Islamic banking financial managers and leaders are drawn from the conventional banking world. They have not been properly trained in Shariah-compliant banking. Hence, it is important to eliminate *riba* (usury) from IBF operations especially in the case of Afghanistan banking system. There are some important Islamic banking bodies such as the Institute of Islamic Banking and Finance (IIBF), IIUM Institute of Islamic Banking and Finance (II*i*BF) and International Centre for Education in Islamic Finance (INCEIF) that organize conferences, collections, special workshops, and trainings. Now is the time for the IBF industry to invest heavily in human resource development and research and training facilities, which can add solutions and real value to present IBF challenges and issues (Khan and Bhatti, 2008). There is also a severe shortage of specialized human resources in Afghanistan, especially in the areas of Shariah supervision, Islamic banking, and Islamic economics due to there is no specific institution that trains such scholars in these areas. Hence, it is common in Afgahnistan that a bank operates Islamic and conventional bank branches under one roof in a same building.

Islamic banks should develop a strong research and training base to nurture a corps of Shariah experts of high moral and professional integrity. In the field of Islamic banking, some scholars are often members of the Shariah board in many Islamic financial institutions. A small number of countries (for example, Indonesia and Malaysia) have restricted the membership number of scholars in Islamic financial institutions' Shariah supervisory board while other countries have not yet made any restrictions (Nomran and Haron, 2020). In fact, in many Shariah boards, particularly in the GCC countries, the names of Shariah scholars have been repeated. Also, three specific Shariah scholars have the membership of 26% of the total Shariah boards in these countries and 11 Shariah scholars have shared 68% positions in all Shariah boards (Grassa, 2016).

DAB issued the policy of the "National Shariah Governance Framework" and various Shariah guidelines such as "Terms of Reference for Shariah Supervisory Board", "Shariah Review Manual" and "Shariah Board Members' Assessment Manual" which might be the guiding principles of the structure of the Shariah governance framework of any Islamic financial institutions in Afghanistan. The "National Shariah Governance Framework" might be a guiding principle for the Shariah governance framework of Islamic financial institutions, to ensure that all Islamic bank's commercial activities and operations are Shariah compliance. Furthermore, due to the nascent stage of Islamic finance in Afghanistan, DAB temporarily authorizes banks to delegate any of their operational functions Shariah governance, as well as their Shariah Board, to a third-party Shariah consultancy (service provider) or an external Shariah Board or a Shariah scholar who approved on other banks Shariah board in Afghanistan. The outsourced Shariah scholars may attend any number of Shariah boards in Afghanistan as long as it deems appropriate. It is also recommended, which at least one qualified Shariah scholar be retained by the bank to be in charge of its Shariah department and to be responsible for complying with Shariah law (Da Afghanistan Bank, 2017).

Providing Shariah-compliant financial products to meet customer demand is an important issue in Islamic banking. In this regard, banks should ensure that their product development processes are comprehensive to not subject to the challenge and possibility of invalidation from the Shariah point of view. To achieve this goal, DAB has issued the "Approval Procedure Manual for Financial Products" for the development of new products for Islamic finance to meet the demand of customers (Da Afghanistan Bank, 2019e).

There is no access to formal financial services by more than half of the adult population in the world, in part because of a lack of credit history and collateral. Advanced access to finance leads to economic growth and financial stability. In this context, access to financial services commensurate with the beliefs and ideas is important (Efendić et al., 2017). The most important issue in the Afghan banking sector is less dealing with banks as previously discussed. Afghanistan's low financial inclusion is due to supply and demand constraints. Disadvantages of the supply side include difficult loan conditions, including high collateral requirements, high-interest rates, lack of experience in SME loans in the banking sector, poor credit infrastructure, which are the main constraint in identifying and managing banks' lending risk, limited access to banks and micro finance institutions especially in rural areas, which includes the absence of digital transactions and branches and lack of business models in banks. Also, about 85% of adults in Afghanistan do not have access to a transaction account. Financial inclusion, income as well as intermediation in Afghanistan are low compared to the region, developing economies, and neighboring countries. This low income makes 54.5% of the country's population live under the national poverty line. The main reasons declared by Afghans for not having an account at a financial institution is, among others; most of them reported lack of funding, as well as some other reasons such as distance, lack of required documents or cost, lack of trust, religious beliefs, or someone else in the family having an account. This indicates the need for the supply side to expand access points, which in turn increases account ownership (Da Afghanistan Bank, 2020).

SME financing in Afghanistan lags behind some other conflicts such as developing economies and low-income. The outstanding SME loans share was only 0.17% of GDP in 2018 that is the lowest among regional and similar economies. Access to finance is one of the biggest barriers that companies face in Afghanistan. About 3.9% of Afghan companies rely on banks loan, and only 0.8 % use banks to raise capital. However, SME's potential credit needs are estimated at more than $4.7 billion, which is a significant opportunity in Afghanistan (Da Afghanistan Bank, 2020).

6. Conclusion

This study explores the challenges of the historical development of the Islamic banking system in Afghanistan using document analysis since the establishment of the banking system in 1933 and since the establishment of the new government in 2001. The country's banking system, which includes Islamic banking as well has been affected by civil wars over the past three decades and has failed to make significant progress. In 2002, the banking system, with the support of the international donors, has undergone significant changes, including the creation of various financial and banking laws, the establishment of new banks, and the re-licensing of previous banks. However, this progress has continued since the formation of the new government, but the banking system has seen a financial crisis in Kabul Bank in 2010 that was one of the Afghanistan's largest commercial banks (CBs). Islamic banking emerged in Afghanistan between 2008 and 2009 and the Islamic Republic Government of Afghanistan is trying to promote Islamic banking activities and have approved licenses for the banks which have Islamic banking windows to convert to full-fledged Islamic banks.

Based on the findings of this study, Afghanistan's banking system even it has seen some development but still faces many challenges, financial services are not available to all adults, and Afghanistan's low financial inclusion is due to limitations in both supply and demand side. Besides, excess liquidity, lack of specialists in the fields of Islamic finance, Islamic economics, and Shariah are the other challenges facing the banking system.

7. Recommendations

Recommendations are provided to improve IBF activities in the country. Universities, government, and financial institutions should focus more on organizing workshops, seminars, conferences or initiating exchange programs with other countries, particularly those known for their leading role in the current Islamic banking and finance industry as a way of motivating people to deal with Islamic banks and increasing their knowledge about Islamic banking and finance.

As the Afghan government has supported Islamic banking activities, but for improving the research activities and come out with some Shariah and IBF scholars it is suggested that the government should establish Islamic banking institutions, faculty, or even universities that are specifically focused on Islamic and Islamic banking studies. It is also suggested that the government should establish, support, and facilitate the Islamic capital market and Islamic money market facilities. This is because the improvement of the Islamic money market and Islamic capital market can increase the financial activities in a country and positively affect the development of a country, specifically for Afghanistan.

References

Abdul-Baki, Z., & Uthman, A. B. (2017). Exploring the "social failures" of Islamic banks: a historical dialectics analysis. *Journal of Islamic Accounting and Business Research, 8* (3), 250-271.

Abdullah, A. (2018). *Money and the real economy from an Islamic perspective*. Kuala Lumpur: Islamic Institute of Islamic Banking and Finance.

Afghan United Bank (AUB). (2019). Retrieved May 30, 2019, from https://www.afghanunitedbank.com/islamic-banking/

Afghanistan International Bank (AIB). (2019). Retrieved May 30, 2019, from https://www.aib.af/

Askari, H., Iqbal, Z., & Mirakhor, A. (2011). *New issues in Islamic finance and economics: Progress and Challenges* (Vol. 753). John Wiley & Sons.

Ahmed, H. (2018). The challenge facing Islamic banking and finance: has it moved away from its core objectives, with special reference to Maqasid. In: *The objectives of Islamic law: the promises and challenges of the Maqasid al-Shari'a*. Lanham, U.S. : Lexington Books.

Akhtar, S., Lorie, H., & Petersend, A. (2009). Effectiveness of central banks and their role in the global financial crisis: case of selected economies. *Asian Development Bank*.

Bank-e-Millie Afghan (BMA). (2019). Retrieved May 30, 2019, from https://www.bma.com.af/#

Bayindir, S., & Ustaoglu, M. (2018). The Issue of Interest (Riba) in the Abrahamic Religions. *International Journal Of Ethics And Systems,* 34 (3), 282-303.

Cerimagic, S. (2010). The effects of Islamic law on business practices. *Education, Business and Society: Contemporary Middle Eastern Issues*, *3*(1), 40-47.

Da Afghanistan Bank. (2015). Legislative Decree of The President of the Islamic Republic of Afghanistan on Issuance of Banking Law of Afghanistan. Retrieved May 25, 2019, from https://dab.gov.af/sites/default/files/2018-12/BankingLawofAfghanistanEnglishTranslation22762018113414921553325325_1.pdf

Da Afghanistan Bank. (2017). National Shariah Governance Framework (Version for Full-Fledged Islamic Banks). Retrieved September 15, 2020, from https://dab.gov.af/sites/default/files/2018-12/9NSGF_IW_for_IslamicWindows_Final_EditedVersion13012017111125847553325325.pdf

Da Afghanistan Bank. (2018a). Quarterly Financial Sector Financial Statistics. Retrieved May 25, 2019, from http://dab.gov.af/sites/default/files/2019-01/Quarterly1final.pdf

Da Afghanistan Bank. (2018b). Regulation for Conversion of a Conventional Bank into an Islamic Bank. Retrieved May 25, 2019, from https://dab.gov.af/Islamic-Banking-Regulations

Da Afghanistan Bank. (2019a). Da Afghanistan Bank History. Retrieved May 25, 2019, from https://dab.gov.af/index.php/dab-history

Da Afghanistan Bank. (2019b). Licensed Financial Institutions. Retrieved May 25, 2019, from http://dab.gov.af/Licensed-Finacial-Institutions

Da Afghanistan Bank. (2019c). Islamic Banking Regulations. Retrieved May 25, 2019, from https://dab.gov.af/Islamic-Banking-Regulations

Da Afghanistan Bank. (2019d). Quarterly financial sector Financial Statistics Q3- 2019. Retrieved from https://dab.gov.af/sites/default/files/2019-11/Q3 2019.pdf

Da Afghanistan Bank. (2019e). Approval Procedure Manual for Financial Products. Retrieved September 15, 2020, from https://dab.gov.af/sites/default/files/2018-12/42Approvalproceduremanualhjtyyutyforfinancialproductsv11-gdffinalversion12120161042647553325325.pdf

Da Afghanistan Bank. (2020). *National Financial Inclusion Strategy 2020 – 2024*. Kabul, Afghanistan. Retrieved from https://dab.gov.af/sites/default/files/2020-06/National Financial Inclusion Strategy for Afghanistanfinal.pdf

Efendić, V., Hadžić, F., & Izhar, H. (Eds.). (2017). *Critical issues and challenges in Islamic economics and finance development*. Switzerland: Springer Nature.

Engku Ali, E. R. A. (2010). *A mini guide to takaful:(Islamic insurance) contracts, products, philosophy, Shariah principles*. Kuala Lumpur, Malaysia: CERT Sdn Bhd.

Ghazanfar Bank. (2019). Retrieved May 30, 2019, from https://www.ghazanfarbank.com/our-profile

Grassa, R. (2016). Corporate governance and credit rating in Islamic banks: Does Shariah governance matters?. *Journal of Management & Governance*, *20*(4), 875-906.

Hassan, M. K., & Lewis, M. K. (2007). *Islamic banking: An introduction and overview*. In: *Handbook of Islamic Banking*, 1-20. Massachusetts: Edward Elgar Publishing.

Hassan, R., Othman, A. A., Salleh, S., & Hussain, M. A. (2016). *Islamic banking and takaful*. Kuala Lumpur: Pearson Malaysia Sdn Bhd.

İncekara, A., & Çetinkaya, H. (2019). Liquidity risk management: A comparative analysis of panel data between Islamic and conventional banking in Turkey. *Procedia Computer Science*, *158*, 955-963.

Islamic Bank of Afghanistan (IBA). (2019). Retrieved May 30, 2019, from http://ibafg.com/letter-of-guarantee/#features

ISRA. (2016). *Islamic financial system: Principles and operations*. Kuala Lumpur: ISRA.

Kamla, R., & G. Rammal, H. (2013). Social reporting by Islamic banks: Does social justice matter ? *Accounting, Auditing & Accountability Journal*, *26*(6), 911-945.

Katzman, K., & Thomas, L. (2017). Afghanistan: post-Taliban governance, security, and US policy. *Current Politics and Economics of the Middle East*, *8*(4), 531-643.

Khan, M. M., & Bhatti, M. I. (2008). Development in Islamic banking : a financial risk-allocation approach. *The Journal of Risk Finance*, *9*(1), 40-51.

Maiwand Bank. (2019). Retrieved May 30, 2019, from http://www.maiwandbank.com/EN/AboutUs.html#PROF

National Bank of Pakistan. (2019). Retrieved May 30, 2019, from https://www.nbp.com.pk/Islamic/Financing.aspx

New Kabul Bank. (2019). Retrieved May 30, 2019, from http://newkabulbank.af/islamic-banking-overview.php

Nomran, N.M., & Haron, R. (2020). Shari'ah governance for Islamic banking: evidence from diverse regulatory environments. In: *Growth and emerging prospects of international Islamic banking*, 213-244. USA: IGI Global.

Charap, M. J., & Pavlovic, J. (2009). Development of the commercial banking system in Afghanistan: risks and rewards (No. 9-150). *International Monetary Fund*.

Pernia, J. D. M., Bell, S. C., & Maimbo, S. M. (2005). The financial sector in Afghanistan: Managing the postconflict reform process. Finance and private sector, South Asia Region, *The World Bank*.

Rostom, A. M. T. (2018). *Afghanistan-modernizing Afghan state-owned banks project* (No. PIDISDSA22512, 1-14). *The World Bank*.

Siddiqi, Y. A. (2019). *Introducing Islamic banking*. Lucknow, India: Dar a-Safwa.

Sutrisno., & Haron, R. (2020). Increasing the role of zakat institutions in poverty reduction through productive zakat programs in Indonesia. *Humanities & Social Sciences Reviews*, *8*(3), 1243-1250

Taqipor, J. (2017). Challenges of and proposals for developing a commercial banking system in Afghanistan. *Afghan Economic Society*, *38*, 1-11.

Turner, B. (2014). *The statesman's yearbook 2015: the politics, cultures and economies of the world.* UK: Palgrave Macmillan.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 26-41
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

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

Aulia Fitria Yustiardhi*, Aulia Arifatu Diniyya, Farihah Amirah Ahmad Faiz, Nur Shazni Subri, Zahra Nabila Kurnia

International Islamic University Malaysia
Kuala Lumpur, Malaysia

**Corresponding author: auliayustiardhi@gmail.com*

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 perceptive 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

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).

Article history:
Received 10 July 2020
Revised 22 September 2020
Revised 25 October 2020
Accepted 4 November 2020

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.

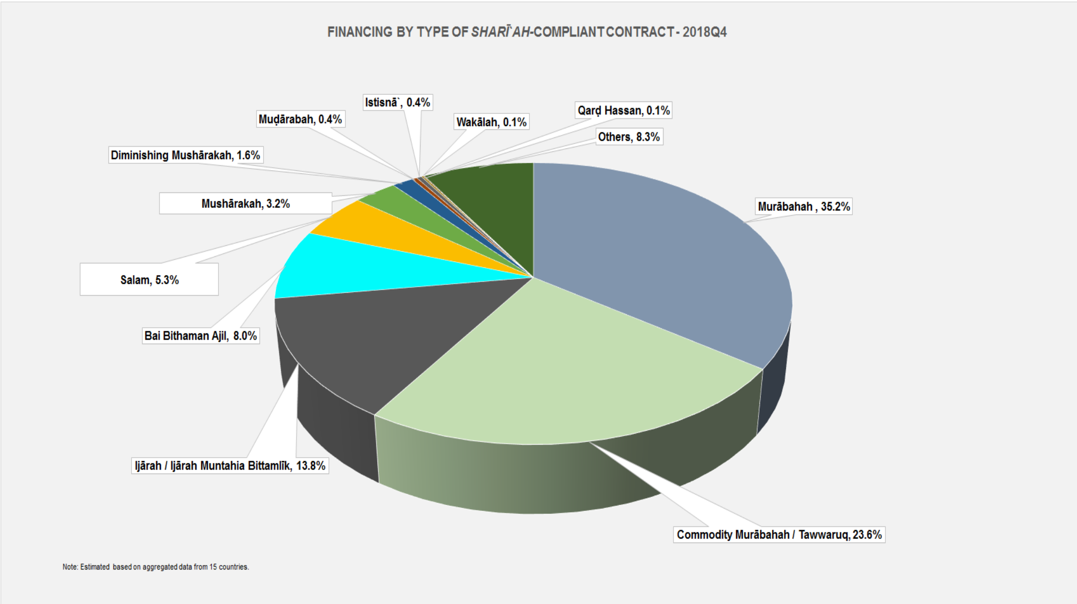
4.1.1. Mudarabah Financing

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.

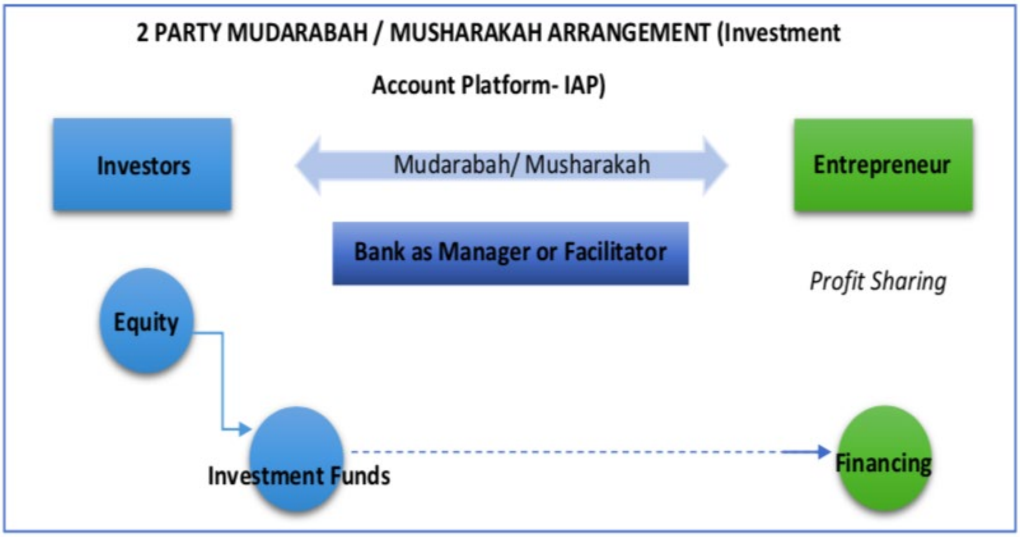
The application of *Mudarabah* and *Musharakah* financing through IAP is varied among the Islamic banks. For instance, Bank Islam Malaysia Berhad (BIMB) with "Restricted Investment Account via IAP" product (Figure 3). BIMB and the investor sign a *Wakalah* contract as the bank will act as an agent of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



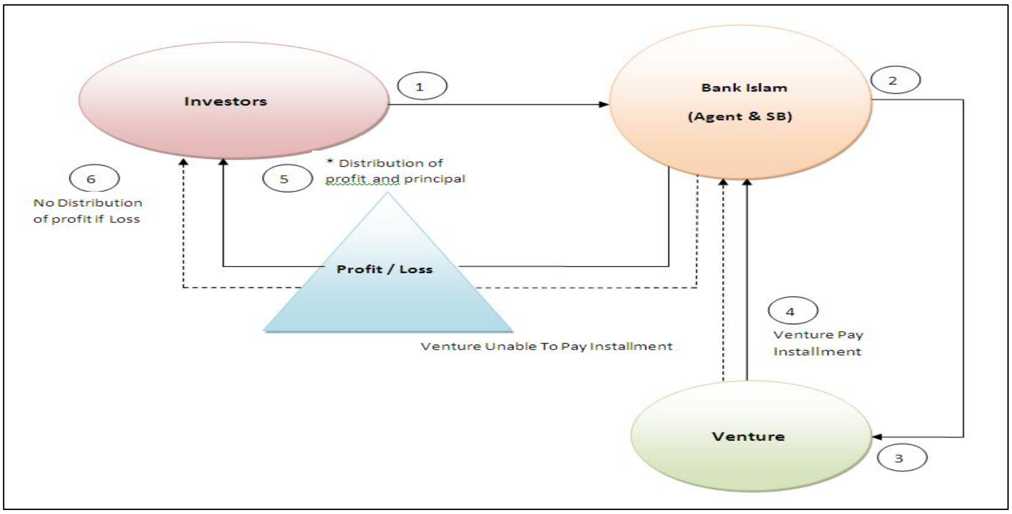
Source: (IFSB, 2019a)

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.

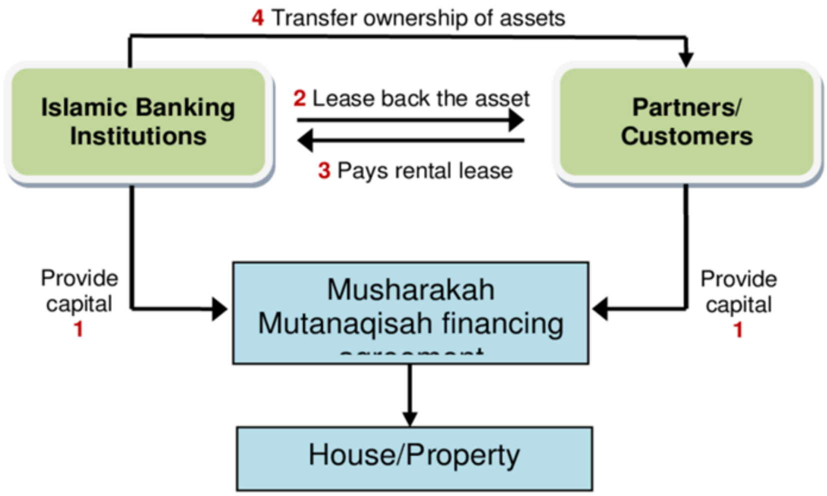
In Indonesia, Bank Syariah Bukopin offers the *Musharakah* financing (Bank Syariah Bukopin, n.d.-b). The contract used is *Musharakah*, which is a collaboration between the bank and the customer to mix their funds or capital in a particular business, with the distribution of profits based on the agreed 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 sub-section 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 loses.

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 Keungan* (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 *Musharakah* and *Mudarabah*	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 *fatwa* issued by the National Sharia Council (DSN) - Indonesian Ulema Council (MUI)
Source of funds	For *Musharakah* and *Mudarabah* 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 *Musharakah/Mudarabah* venture; benchmark rate of return of the equivalent product; and estimated management or operational costs incurred by the managing partner in managing the *Musharakah/Mudarabah* 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 *Musharakah* 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 *Musharakah* and *Mudarabah* ventures may require collateral or a guarantee. However, it shall only be liquidated in the event of misconduct *(ta`addi)* or negligence *(taqsir)* or breach of specified terms *(mukhalafah al-shurut)* 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 *Mudarabah* will also bear 400% of risk-weighted for private commercial enterprise and *Mudarabah* 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 *Mudarabah* 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 *Mudarabah* exposures under the standardised approach. BNM capital requirements show its support for Islamic banks in Malaysia to offer *Musharakah* and *Mudarabah* 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 *Mudarabah* and *Musharakah* ventures are 400% risk-weighted for shares that are not publicly traded less any specific provisions for impairment	- 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	*Musharakah* and *Mudarabah* 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 *Mudarabah* 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.

References

Al-Dardir, A. Abu al-Barakat, *al-sharh al-kabir*. (n.d.). Beirut: Dar al-Fikr.

Adewale, A. A., & Archer, S. (2019). Risk sharing in Islamic banking. *IFSB Working Paper Series*. Kuala Lumpur, Malaysia: IFSB.

Abdul-Rahman, A., & Nor, S. M. (2016). Challenges of profit-and-loss sharing financing in Malaysian Islamic banking. *Malaysian Journal of Society and Space*, *12*(2), 39–46.

Afzal, T., & Hassan, S. (2018). Hindrance of mudharabah financing: a study from islamic banking industry of Pakistan. *International Journal of Islamic Banking and Finance Research*, *2*(2), 16–23.

Ahmad, W. M. W., Rahman, A. A., Seman, A. C., & Ali, N. A. (2008). Religiosity and banking selection criteria among Malays in Lembah Klang. *Jurnal Syariah*, *16*(2), 279–304.

Arshad, N. C., & Ismail, A. G. (2010). *Shariah parameters for Musharakah contract : a comment*. *1*(1), 145–162.

Ashraf, H., & Hussain, L.H. (2011). Mudarib di dalam kontrak Muḍārabah. *Muzakarah Cendikiawan Syariah Nusantara 2011*. Phuket, Thailand.

Bank Islam. (n.d.). *Restricted Investment Account (RIA) via Investment Account Platform (IAP)*.

http://www.bankislam.com.my/home/business-banking/financing-programme/ria-via-iap/
Bank Syariah Bukopin. (n.d.-a). *Mudharabah*. https://www.syariahbukopin.co.id/id/produk-dan-jasa/pembiayaan/mudharabah
Bank Syariah Bukopin. (n.d.-b). *Musyarakah*. https://www.syariahbukopin.co.id/id/produk-dan-jasa/pembiayaan/musyarakah
Bank Syariah Mandiri. (n.d.). *Mudharabah*. https://www.mandirisyariah.co.id/business-banking/corporate/pembiayaan-modal-kerja/mudharabah
BCBS. (2018). *Calculation of RWA for credit risk.* Retrieved from https://www.bis.org/basel_framework/chapter/RBC/20.htm?inforce=20220101#paragraph_RBC_20_20220101_RWA_for_credit_risk.
BNM. (2012). *Shariah Standard on Mudarabah*. https://www.islamicfinance.com/wp-content/uploads/2015/01/shariah_std_mudarabah.pdf
BNM. (2015a). *Shariah Standards and Operational Requirement on Mudarabah* (Issue April, p. 64). https://www.bnm.gov.my/index.php?ch=57&pg=137&ac=418&bb=file
BNM. (2015b). *Shariah Standards and Operational Requirement on Musyarakah*. https://www.bnm.gov.my/index.php?ch=57&pg=137&ac=416&bb=file
Borhan, J. T. (2004). The agent-manager ' s conduct of Mudarabah contract in Islamic commercial law. *Jurnal Syariah*, *12*(1), 1-20.
Bushman, R. M., & Wittenberg-Moerman, R. (2012). The role of bank reputation in "certifying" future performance implications of borrowers' accounting numbers. *Journal of Accounting Research*, *50*(4), 883-930.
Echchabi, A., & Olaniyi, O. N. (2012). Malaysian consumers' preferences for Islamic banking attributes. *International Journal of Social Economics*, *39*(11), 859–874.
Haron, R., Abdul Subar, N., & Ibrahim, K. (2020). Service quality of Islamic banks: satisfaction, loyalty and the mediating role of trust. *Islamic Economic Studies*, *28*(1), 3-23.
IFSB. (2013). *Islamic Financial Services Industry Stability Report 2013*. https://www.ifsb.org/download.php?id=4415&lang=English&pg=/sec03.php
Ibn-Manzur, M.M. (2005). *Lisan al-'Arab.* Bayrut: Dar Sadir.
IFSB. (2019a). *Key Exhibits PSIFIs Data*. Islamic Financial Services Board. https://www.ifsb.org/sec03.php
IFSB. (2019b). *Risk Sharing in Islamic Banking* (WP-10/05/2019; Issue May). http://www.ifsb.org/docs/WP-03-Consumer Protection(final).pdf
Islam, R., & Ahmad, R. (2020). Applicability of Mudarabah and Musharakah as Islamic micro-equity finance to underprivileged women in Malaysia. *European Journal of Development Research*, *32*, 176–197.
Islamicbankers.me. (n.d.). *Financing : Musharaka*. https://islamicbankers.me/islamic-banking-islamic-contracts/financing-musharaka/
ISRA. (2016). *Islamic financial system: Principles and operations*. ISRA: Kuala Lumpur.
Jais, M., Sofyan, F., & Bacha, A. M. (2019). Mudarabah and Musharakah as an equity financing model : issues in practice. *Proceedings of the 2nd Aceh Global Conference on Business Economic and Sustainable Development Trends (AGC-BEST) 2019*, 107–114.
Muhammad, A.M. (2014). Critical analysis of some of the major internal hindrance factors in the application of Musharakah financing by the Islamic Banks. *International Journal of Education and Research*, *2*(9), 125–142.
Maali, B., Casson, P., & Napier, C. (2006). Social reporting by Islamic banks. *Abacus*, *42*(2), 266–289.
Mazuin, N. (2016). An evolution of Mudarabah contract : a viewpoint from classical and contemporary Islamic scholars. *Procedia Economics and Finance*, *35*, 349–358.
Muhammad. (2005). *Konstruksi Mudharabah dalam bisnis Syariah* (First). BPFE Yogyakarta.
Naim, A. M., Bakar, M. Ab., Hussein, M. N. M., & Long, M. N. H. (2016). Issues and challenges in offering Mudarabah and Musharakah products in Islamic finance. *Jurnal Pengurusan*, *46*, 137 - 147.
Nik Muhamad, N.A., Abdul Hamid, A., Bahrom, H., Haniff, M.N., Ab Manan, S.K., & Abdul Aziz, R. (2013). Customers ' preference on Islamic banking products and services : the influence of knowledge , awareness and satisfaction. *12*(1), 1–23. *Management & Accounting Review*, *12*(1), 1-23.
OJK. (2015). *Credit Risk-Weighted Assets Requirements Using Standardised Approach For Islamic Banking*. https://www.ojk.go.id/id/regulasi/otoritas-jasa-keuangan/surat-edaran-ojk-dan-dewan-

komisioner/Documents/Pages/Surat-Edaran-Otoritas-Jasa-Keuangan-Nomor-34SEOJK032015/SALINAN-Risiko Kredit - Batang Tubuh-DPBS.pdf

OJK. (2018). *Statistik Perbankan Syariah (SPS) Desember 2018*. https://www.ojk.go.id/id/regulasi/otoritas-jasa-keuangan/surat-edaran-ojk-dan-dewan-komisioner/Documents/Pages/Surat-Edaran-Otoritas-Jasa-Keuangan-Nomor-34SEOJK032015/SALINAN-Risiko Kredit - Batang Tubuh-DPBS.pdf

Onagun, A. I. (2017). Musharakah financing as addressed in ifsb standard: a regulatory perspective. In: *leadership, innovation and entrepreneurship as driving forces of the global economy* (pp. 783-793). Springer.

Saad, N. M., & Razak, D. A. (2013). Towards an application of Musharakah Mutanaqisah principle in Islamic microfinance. *International Journal of Business and Society*, *14*(2), 221–234.

Sabrina, & Abd Majid, M. S. (2020). *The reluctance phenomenon of Islamic banks to offer profit-loss sharing financing*. *Journal of Economics and Policy*, *13*(2), 242–264.

Sadique, M. A. (2009). *Essentials of Musharakah and Mudarabah: Islamic texts on theory of partnership*. Kuala Lumpur: IIUM Press.

Sapuan, N. M. (2016). An evolution of Mudarabah contract: a viewpoint from classical and contemporary Islamic scholars. *Procedia Economics and Finance*, *35*(October 2015), 349–358.

Selvanathan, M., Nadarajan, D., Farzana, A., Zamri, M., Suppramaniam, S., & Muhammad, A.M. (2018). An exploratory study on customers' selection in choosing Islamic banking. *International Business Research*, *11*(5), 42–49.

Shodiq, M. (n.d.). *Mudaraba and Musharakah: Problems and the Solutions*. http://islamicfinance-global.blogspot.com/2012/11/mudaraba-musharakah-problems-solutions.html

Siddique, M. N.-E.-A. (2012). Bank selection influencing factors: a study on customer preferences with reference to Rajshahi city. *Asian Business Review*, *1*(1), 80-87.

Spinassou, K., & Wardhana, L. I. (2018). *Regulation of Islamic banks: Basel III capital framework and profit-sharing investment accounts*. https://hal.archives-ouvertes.fr/hal-01674376v3

Usmani, M. T. (1998). *An introduction to Islamic finance*. https://muftitaqiusmani.com/en/books/PDF/An Introduction To Islamic Finance/An_Introduction _to_Islamic_Finance.pdf

Yusof, A. A. (2017). *Shariah Standards & Operational Requirement*. https://islamicbankers.files.wordpress.com/2017/09/shariah-standards-mia-280917-final.pdf

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 42-58
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Shariah Audit Practices in Malaysia: Moving Forward

Fatihu Shehu Isa, Noraini Mohd Ariffin*, Nor Hafizah Zainal Abidin

*Department of Accounting, Kulliyyah of Economics and Management Sciences,
International Islamic University Malaysia*

**Corresponding author: norainima@iium.edu.my*

Abstract

The Shariah audit being a monitoring tool for ensuring Shariah compliance proved to be an important component in the operations of Islamic financial institutions (IFIs). In the case of Malaysia, Bank Negara Malaysia has issued a Shariah Governance Framework in 2010 which categorically made Shariah audit function as one of the required functions in IFIs in addition to Shariah Review, Shariah Research and Shariah Risk Management. In line with this, this study aimed at exploring the extent of practitioners' awareness and perceptions of Shariah audit, the possible challenges associated with it as well as its future implications. The study used 83 practitioners drawn from various IFIs external audit firms that are involved in Shariah audit services through purposive sampling procedure. Questionnaire instrument was employed in generating the data. The findings of the study showed that practitioners' awareness is satisfactory, as majority of them got to know about Shariah audit through an educational programme, which gave them the opportunity to express what ought to be the desirable practice of Shariah audit. Similarly, the findings revealed that the lack of the independent Shariah audit report, the standalone Shariah audit framework and the inadequate competent Shariah auditors are among the main concerns in the practice. Moreover, the findings also showed that Shariah audit will have a high potential to take up as a marketable career in the near future. Finally, the findings suggest that the integration of Shariah audit in accounting courses in institutions of higher learning; comprehensive Shariah audit framework and standards; new regulatory/professional body with a mandate of supervising IFIs as well as a professional certification in Shariah audit should be made available. It is hoped that the study will contribute towards the development of desired Shariah audit practices in Malaysia.

Keywords: Shariah audit, Islamic financial institutions, questionnaire survey, Malaysia

1. Introduction

Globally, the remarkable growth of the Islamic financial industry in recent years has been triggered by the strong demand for Islamic banking services to ensure all transactions are compliant with Shariah. The rapid growth in the industry has initiated significant changes in most of its current activities and this has had an effect on the auditing, accounting and economics professions, among others. There is a crucial need for a proper system of checks and balances in the industry to safeguard the reputational risk in lieu of Shariah non-compliance activities. A robust monitoring system would enhance and preserve the public's confidence in the operations and activities of the industry, and it has been argued that the audit function is ideal in serving this purpose (Yaacob and Donglah, 2012). In fact, the presence of Shariah audit, as the third line of defence, is to ensure that the overall processes and activities in Islamic Financial Institutions (IFIs) are not contravened to the Shariah principles (Yasoa et al., 2018). In the field of auditing, the sole objective of Shariah audit, in addition to conventional audit, is to attest to Shariah compliance.

However, in the context of Malaysia, many aspects of Shariah audit, including Shariah auditors' certifications, competency requirements, professional judgement standards and reporting structures, as well as Shariah audit framework, are not adequately covered by the Shariah Governance Framework (SGF 2010), which was introduced in 2010 (PwC, 2011). Indeed, a number of previous studies have raised several concerns in relation to the provision of guidelines on Shariah audit practices in IFIs, the competency of

Article history:
Received 18 June 2020
Revised 22 September 2020
Accepted 3 October 2020

Shariah auditors and the challenges of Shariah audit practices (Abdul Rahman, 2008; Haniffa, 2010; Kasim, 2010; Shafii et al., 2013). Careful scrutiny of SGF 2010 indicated that it places little importance on providing adequate explanations on the functions of the Shariah audit (Abdul Rahman, 2014). Many studies have expressed the opinion that the framework is too brief in relation to providing a generally accepted procedure for the performance of a Shariah audit (Abdul Ghani and Abdul Rahman, 2015; Abdul Rahman, 2014; Shafii et al., 2013; Shaharuddin, 2011). In addition, SGF 2010 does not pay much attention to providing a specific guide on the types of Shariah knowledge and the areas of Shariah in the framework needed by the internal auditors in order to conduct effective Shariah audit (Abdul Rahman, 2014). Whereas, in 2019, the revised Shariah Governance Policy Document (SGPD 2019) merely noted that the Shariah audit must be performed by a qualified person that has requisite knowledge on Shariah requirements applicable to the IFIs (Bank Negara Malaysia or BNM, 2019). Nevertheless, PwC (2011) emphasised that there is an urgent need to increase the number of competent and knowledgeable Shariah auditors, establish a Shariah audit framework and standards, and enhance Shariah audit methodologies. Echoing such need, Abdul Rahman (2014) expressed his concerns on the inconsistency of the current Malaysian Shariah audit practices if the Shariah audit framework is not made available. After all, the credible performance of the Shariah audit is crucial in order to enhance the faith and confidence of various stakeholders in the industry.

Therefore, in order to understand the current state of Shariah audit, this study explores Shariah practitioners' awareness and perceptions of Shariah audit practices in the Malaysian context. Insights on the challenges associated with the current practices and their implications for the future direction of Shariah audit in Malaysia are also discussed. Furthermore, there are several ways in which this study has contributed to the literature. To date, a limited number of studies have focused on the perceptions of practitioners, who are directly involved in the control functions under Shariah governance with regard to the issues and challenges they face in their current practices. In addition to that, prior studies were mostly conceptual and lack of empirical input from practitioners. Therefore, in this study, the perceptions of practitioners were gathered from three different groups, namely internal and external Shariah auditors and Shariah officers, who could offer up-to-date insights on Shariah audit practices from a range of perspectives. Finally, this study uncovers several important insights for future improvement of Shariah audit practices, including the need for SGPD 2019 to focus more on strengthening the positioning (structure) of Shariah audit activities within the IFIs and to provide more detailed guide on the scope and methodology of Shariah audit, as well as a need for more qualified Shariah auditors to be trained in the areas of accounting and *fiqh muamalat* (Islamic commercial jurisprudence).

The findings of this study also highlight several emerging issues that need to be addressed in order to move forward in improving Shariah audit practices, which lead to four key recommendations. First, dedicated in-house internal audit units should be set up in IFIs. Second, a clear line of functional reporting or authority should be included in the internal audit charter, which would enhance the independence of the audit function, i.e. by providing unfettered powers of inquiry and reporting. This would strengthen the positioning and recognition of independent internal Shariah audit activity. Third, the educational sector and professional bodies should focus on producing more qualified and competent human resources for performing Shariah-related work. Finally, Shariah audit practices should be standardised through the proper introduction of a Shariah audit framework or guideline. Besides, the presence of framework is crucial to establish efficiency and help to define the work, authority and reporting level.

The remainder of the paper is structured as follows: in the next section the prior literature is reviewed, and this is followed by an explanation of the research method. Then the results of the analysis are presented and discussed. Finally, the paper ends with some concluding remarks, highlighting the implications, limitations of the study and some suggestions for future research.

2. Literature review

2.1 Shariah Governance

The Islamic Financial Services Board (IFSB) Guiding Principles on Corporate Governance took the position that 'no single model' suits all IFIs globally and the effectiveness and soundness of a corporate governance framework depends on the specificities of the individual IFI (IFSB, 2009). Due to this, the IFSB (2009) recommended that the implementation of the guiding principles should be proportionate to the size, complexity, structure, economic significance and risk profile of each IFI. IFSB defined the Shariah governance system as a set of institutional set up within an IFI. It aims to ensure an effective oversight mechanism on Shariah compliance over the structures, operations and activities of IFIs are in place. In the case of Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), no proper definition is provided with regard to SG, however, several standards (i.e. Standard No. 1, 2, 4, 6 and 7) of AAOIFI stated the roles and conducts of Shariah organs of IFIs. However, SGF issued by the Central Bank Malaysia (BNM) is used in the case of IFIs in Malaysia. These guidelines are used to assist IFIs to establish their governance structures and improve its transparency (Shafii and Salleh, 2010).

In the context of Shariah audit in Malaysia, the BNM, in an effort to establish proper Shariah compliance in IFIs, issued SGF in 2010 (BNM, 2010) (thereafter SGF 2010), which later was revised to SGPD in 2019 (BNM, 2019) (thereafter SGPD 2019). In between, the Islamic Financial Services Act (IFSA) was passed into law in 2013 (BNM, 2013). SGF 2010 contains sections on Shariah risk management, Shariah review, Shariah research and Shariah audit functions, whereas the IFSA was designed to encourage Shariah compliance in IFIs. Hence, the requirements of SGF 2010 are mandatory for all IFIs as its implementation is mandated by the law stipulated in IFSA (2013). The Act also highlighted various penalties for Shariah non-compliance (SNC). Both SGF 2010 and IFSA 2013 were meant to ensure adequate implementation of Shariah compliance across Malaysian IFIs. In addition to that, the SGPD 2019 further strengthened the oversight functions of the Shariah Committee and other Shariah control functions to continuously ensure strong practices of Shariah compliance within the IFIs. The emphasis on Shariah non-compliant events are further governed by Operational Risk Integrated Online Network (ORION) (BNM, 2018). Close monitoring on Shariah non-compliant events is being done by BNM through reporting submitted by IFIs.

SGF 2010 clearly stated that the presence of SG organs is to observe comprehensive compliance with regard to Shariah principles in all conditions. This would uphold the confidence of the general public and financial markets towards IFIs in Malaysia. Definitely, Shariah Committee, being the heart of SG, owe fiduciary and oversight duties towards the stakeholders (Kasim et al., 2016). The role of the Shariah Committee is to supervise the bank and confirm that the products and operations are in compliance with the Shariah requirements. In the case of SNC, the Shariah Committee should advise ways to solve the issues by the provision of alternatives in compliance with Shariah for the Board to decide. SGF 2010 also stated that Shariah compliance functions, comprising Shariah review, Shariah risk management and Shariah audit functions, to perform robust monitoring of Shariah compliance. For instance, Shariah review performs a regular assessment of activities and operations towards Shariah compliance of IFIs by qualified Shariah officers. Shariah risk management ensures risk management activities (risk identification, risk assessment, risk management) to mitigate SNC risks to be in place. While Shariah audit performs periodical assessment and provides independent assurance on the degree of compliance. The scope of the Shariah audit would cover all aspects of IFIs operations, including financial statements, people, processes and information technology application systems. These functions are often being supported by Shariah secretariat, comprised of Shariah officers, to undertake the administrative and secretarial matters as well as to conduct research and vetting of the pre-product approval process.

The structure of SG, as mentioned earlier, is in line with the requirements of the Basel Committee. Basel Committee on Banking Supervision (Goodhart, 2011), as asserted by Institute of Internal Auditors (IIA) (2013), aligns the interests of stakeholders through the emphasis of three lines of defence which specify that to increase monitoring efficiency in banking operations, adequate governance structure of management (1st line of defence), control functions like compliance and risk management (2nd line of defence) and internal audit (3rd line of defence) should be established. Therefore, in the case of IFIs, Shariah Review and Shariah Risk Management are classified as the second line of defence, which oversees the activities performed by the management are in compliance with the Shariah requirements (Shafii et al., 2015a). Shariah Committee would oversee the work and evaluate the report from these functions. Whilst, Shariah Audit, in providing objective assurance, is considered as the third line of defence that ensures the overall policies and procedures of the IFIs operations are in place and consistently implemented. A report from Shariah Audit is then communicated to the Audit Committee in respective IFIs. These components of Shariah governance systems should serve as an effective tool in managing and monitoring SNC risk.

Studies also affirmed that preceding requirements underlined the importance of SG in overseeing the practices and conducts of operations and activities of IFIs are espoused by Shariah principles (Chapra and Ahmed, 2002; Grassa and Matoussi, 2014). Essentially, the main duty of SG is to promote fair and just financial transactions that would benefit all involved parties and the prevailing focus of the organs of Shariah governance is accountability and transparency towards stakeholders in particular and *ummah* (community) in general. In addition, Khalid (2020) stipulated that presence of audit and governance committee also may enhance the effectiveness of Shariah auditors in IFIs.

2.2 Shariah Audit Practices

IFIs must abide by Shariah precepts in all their business and financial transactions. This promotes social justice, equity, moderation and a balanced relationship (Kasim, 2010). The concept of *Hisbah* was institutionalised in the early days of Islam. *Hisbah* is a religious responsibility in which its role is to uphold the truth and forbid all wrongdoings in the society. This means that those who hold the responsibility must be truly qualified so that all the Islamic guidelines can be upheld.The role of a *Muhtasib* (a member of the *Hisbah* institution) is to monitor, control and prevent the fraudulent exploitation of consumers in the marketplace. *Muhtasib* is a noun taken from the Arabic word "*Hisbah*" itself which means someone who is responsible to uphold good or *ma'ruf* and forbid wrongdoings or *munkar* in the Muslim society. In addition, the tradition of *Hisbah* relies on the concept of enjoining good and forbidding evil (Nahar and Yaacob, 2011). Hence, the *Hisbah* function is important and it reflects the accountability of the auditor not only to users of financial statements but more importantly to Allah. The *Muhtasib* is a person who has the knowledge and qualification in Shariah economics, and who is able to advise and give an opinion on certain matters and issues that are in conflict with the code of conduct and Shariah (Yaacob, 2012). In line with the preceding arguments, the presence of Shariah audit is supported by agency theory. Main objective of the agency theory is to enhance accountability through providing a fair flow of information between the principal and agent as a result of information asymmetries and differing motives. In doing so, the trust and accountability is being enforced through the work of Shariah auditor that acts as the monitoring mechanism in ensuring the truthfulness of the information provided. In fact, assurance provided by Shariah audit practices in ensuring Shariah compliance is pertinent to enhance IFIs integrity and public confidence (Abdul Ghani et al., 2019).

According to Hameed (2000), under the Islamic worldview, auditors need to attest compliance with *Maqasid al-Shariah* (Objective of Shariah), including, for instance, the *maslahah* (public interest) of *ummah* and accountability. This is in line with the objectives of SGF 2010 that is to ensure accountability, and proper oversight are done through the establishment of organs of SG functions, whereas conventional auditors only need to attest and assure compliance as well as effectiveness against international practices. This view is supported by Abdul Rahman (2008) who stated that Shariah compliance is the cornerstone of Islamic financial products and services and if customers were to find that the products that they have in their portfolio are not Shariah compliant, this would seriously undermine the confidence in the Islamic financial services industry as a whole.

The tremendous growth in Islamic finance has seen the assets under the management of IFIs grow to in excess of one trillion US dollars (Dar et al., 2012). Inevitably, there is a need to have a proper audit system in place for IFIs to continue growing and to provide an assurance that they are strictly following Shariah in all its aspects. Therefore, IFIs have greater fiduciary duties and responsibilities towards their stakeholders than conventional institutions (Abdullah and Pillai, 2010). They must comply with Shariah in aspects of their operations and management and thus Shariah audit can be seen as a process to attest Shariah compliance. A considerable number of studies have highlighted a range of issues of great concerns related to Shariah audit practices in Malaysia. These include the absence of a proper Shariah audit framework and lack of generally accepted Shariah audit standards used by IFIs, as well as an insufficient number of competent Shariah auditors in terms of qualifications, competence and experience (Ali et al., 2016; Najeeb and Ibrahim, 2014; Othman and Ameer, 2015; Shafii et al., 2014a).

The conventional auditing framework (the International Professional Practices Framework) is limited in terms of its scope in relation to auditing practices in Islamic institutions, which requires a different perspective (Kasim et al., 2009). The conventional financial audit is inadequate to fulfil the needs of the stakeholders of IFIs (Haniffa, 2010) because the International Standards on Auditing do not take into account the Shariah aspects. Haneef (1997) highlighted that there was an urgent need for Islamic economics, Islamic banking and finance and as well as accounting and auditing for IFIs to have their own frameworks and use their own criteria. Essentially, the practices in these fields require a different epistemology framework to distinguish between Islamic thought and conventional thought. The development of such frameworks should fit the specific context of Shariah audit practices, culture, business environment, policies, and regulations. The industry was recommended to adopt a common internal Shariah audit framework as a move towards achieving standardisation and uniformity of audit practices (Yussof, 2013). After all, the absence of a comprehensive framework and different standards used in different countries often cause inconsistencies in Shariah audit practices (Alam et al., 2017; Puad et al., 2015). This can be supported by Alahmadi et al. (2017), who reported that the absence of the Shariah audit framework has caused ambiguity and inconsistencies in Shariah audit practices in Saudi Arabia. It creates a discernible gap in practices particularly in Islamic windows, which are exposed to more SNC risks compared to full-fledged Islamic banks.

In a similar vein, Abdul Rahman (2014) revealed three shortcomings in SGF 2010 and also highlighted issues related to the source of internal auditors performing Shariah audit. First, SGF 2010 requires the Shariah audit to be performed by the internal audit unit of each IFI. However, a thorough study of SGF 2010 indicated that the framework failed to adequately define the function of Shariah audit. Second, the SGF 2010 further requires the function of the Shariah audit to be carried out by internal officers who have sufficient Shariah knowledge. Again, the framework lacked in detail because it did not specify the extent or the specific areas of Shariah knowledge the officers should possess. Abdul Rahman (2014) argued that those who are educated in religious education may not be well versed in banking and finance knowledge, thus they would require additional training to undertake such a task. Third, Abdul Rahman (2014) also claimed that the function of the external Shariah auditor was purposely omitted from the framework. On a flip side, the revised SGPD 2019 stated that Shariah audit could be performed by qualified internal auditors or independent external auditors. Shafii et al. (2015b) commented that the source of the Shariah audit could be executed in three mechanisms, namely in house, outsource or co-source. Besides, the Shariah audit unit can even be an independent standalone unit, as practiced in Kuwait, Bahrain and Qatar (Shafii et al., 2015b) or a leverage model where the qualified Shariah auditors formed part of the internal audit activity. Respective model or structure would influence the degree of independence subjected to the competency level required within the specific contexts of respective IFI. In addition, Arman (2013) stated that internal Shariah audit could reduce the cost incurred and leakage of internal information, while external Shariah audit would be able to gain access to a broader range of expertise and is able to express independent opinions towards the work of Shariah compliance. Recent SGPD 2019 also supported that IFIs may appoint an independent external Shariah audit if deemed necessary.

Issues related to competencies for Shariah auditors are also discussed in other countries such as Saudi Arabia, Bangladesh, Indonesia, Pakistan and Oman (Alahmadi et al., 2017; Alamgir, 2014; Alam et al., 2017; Arwani, 2018; Muhammad and Sulong, 2019; Abdul Ghani et al., 2019). Yaacob and Donglah (2012) also found that Shariah audit practices are in need of improvement in the understanding of Shariah audit among internal auditors, enhancement of Shariah knowledge and standardisation of Shariah audit framework. Preceding studies concluded that competencies comprise of knowledge and skills are pertinent to enhance awareness among employees performing the operational duties and making decisions in the right direction. For instance, highly competent managers in the IFIs should able to differentiate the faith-based or profit-motive decisions to be made in relation to business and investment transactions. Furthermore, Shariah compliance culture could be strengthened through continuous training to all employees in IFIs (Ali et al., 2017). Lack of understanding and ignorance would become serious obstacles which might create more negative attitudes and perceptions towards Shariah compliance practices. Thus, effective training would enhance awareness and knowledge which are translated into a higher level of employee commitment towards Shariah compliant activities.

On the other hand, Kasim et al. (2009) explored the gap between desired and actual practices of Shariah audit in Malaysia. The results found that Shariah audit practices at that point in time were no different from the conventional ones due to the similarities in their process and procedures. Furthermore, the scope of the Shariah audit was restricted to product compliance. Therefore, it seems reasonable that the concept of Shariah audit should be extended to activities related to, among others, the processes, products, employees, environment and society (Sultan, 2007). The scope of Shariah audit should cover areas that could potentially result in non-compliance issues which include products and services, financial reporting, organisational structure, human resources, processes, marketing and IT (Kamaruddin and Hanefah, 2017). A study by Shafii et al. (2014b) showed that the scope of the Shariah audit has been extended to include business policies, procedures, internal control systems, and assessment of financial resources. For instance, financial statements should constitute part of the scope in Shariah audit. The extent of recording, reporting, disclosure and internal control in respect of financial activities needs to be considered in the assessment of SNC since it may not be covered by the external auditors in the conventional financial statement audit (Shafii et al., 2015b). In short, preceding issues need to be rectified and the presence of obstacles may hinder the progress of Shariah audit practices which is explained further in the next section.

2.3 Challenges of Shariah Audit

The absence of a proper framework to govern the practices of internal and external Shariah audit in IFIs has challenged IFIs to develop their own internal Shariah audit architecture (Shafii et al., 2014b). Shafii et al. (2013) opined that it is extremely important to develop human capital to conduct the Shariah audit effectively. The authors claimed that since the commencement of the modern practice of Shariah audit, the adequacy of independence, competence, and quality of Shariah auditors have often been questioned and revisited. The study concluded that Shariah auditors should possess both Shariah and strong accounting knowledge. Furthermore, the competency and independence of Shariah auditors are greatly dependent on the source of the Shariah audit itself either sourced internally or externally (Ali, 2018) and it was indeed difficult to get the right staff with auditing and Shariah skills (Ali et al., 2016). In most cases, the team of Shariah audit would comprise of a mixed background from auditing, accounting, banking and Shariah background. Ali et al. (2016) found that mixed practices were adopted and local IFIs preferred to appoint Shariah auditors from a mixed background of qualifications, consisting of individuals from accounting, banking and Shariah background, while foreign IFIs preferred to have Shariah audit to be conducted by individuals with an accounting background.

On another note, there is a mismatch as to what is required by the banks and what is offered to the markets (Ali et al., 2015). Therefore, Ali et al. (2015) and Shafii et al. (2014a) suggested that a proper development and management of human talent is needed in order to generate an ample pool of competent and qualified Shariah compliance officers and Shariah experts who can spearhead the innovation of Islamic products and services. This would ensure access to credible experts in Shariah knowledge who would be well versed in handling Shariah-related issues and whose decisions would then influence the quality of the Shariah audit profession as a whole. Besides, continuous acquisition of new knowledge is also done through job training and attending related courses on Shariah provided by several Islamic finance training centres (Ali, 2018). According to Alamgir (2014), training is equally important to all employees in creating awareness of the needs for Shariah compliance. Moreover, it develops a continuous understanding of the Shariah issues, strengthens the belief and improves acceptance towards Shariah compliance in banking operations.

Furthermore, Najeeb and Ibrahim (2014) also highlighted the importance of professional certification or qualification in enhancing technical knowledge and professional skills in the area of Shariah requirements. The study also underlined that the presence of Shariah scholars would probably help in strengthening the extent of compliance and better handling of the issues with regard to Shariah rules and principles in determining Shariah-compliant status. In addition to that, the study by Shafii et al. (2014b) also suggested that the elements of industry knowledge and *fiqh muamalat* should be considered in the certification programme as it will promote professionalism and improve the conduct of Shariah audit in the industry.

In their study on the trends in Bahrain, Khalid et al. (2017) highlighted the importance of an independent and competent internal Shariah audit. This independence is determined by the reporting level, direct interaction with those in charge with governance, unrestricted access to information as well as appointment and removal of the head of the internal Shariah audit unit. However, the authors found that independence is not statistically significant in terms of influencing the effectiveness of the internal Shariah audit. They suggested that this finding is due to the variations in Shariah audit practice in Bahrain, where the activity can be performed by either internal or external auditors, whose scope of work differs in terms of remit. On the other hand, the authors found that competence and work performance are statistically significant in determining Shariah audit effectiveness. Moreover, in the study by Yasoa et al. (2018), management support may also contribute to the effectiveness of Shariah audit.

In short, prior studies have mainly argued that the absence of a comprehensive Shariah audit framework undermines the possibility of standardising audit practice. In addition, the level of qualifications of Shariah auditors seems to be an important issue in ensuring the future supply of qualified human capital in the Shariah audit profession. The independence of the Shariah audit function has also been highlighted as another issue that could undermine the quality of the Shariah audit. Eventually, scarce resourceful Shariah auditors with Shariah, accounting or auditing qualifications might lead to the threats of independence which may affect the reputation and growth of the IFIs (Kasim and Sanusi, 2013). In tandem with the rapid growth of IFIs, the identified issues should be resolved as soon as possible by relevant authorities in order to ensure the robustness and integrity of IFIs.

3. Method

The empirical data for this study were collected by means of a questionnaire survey. The self-developed instrument contained five sections. Seven items in section A assessed practitioners' awareness of Shariah audit practices. Section B to D covered practitioners' perceptions of current Shariah audit practices (7 items), challenges (5 items) and future implications (7 items). The respondents were required to indicate the relative importance of all items in Section A to D a four-point Likert scale (1: Strongly Disagree; 2: Disagree; 3: Agree; 4: Strongly Agree). Section E gathered respondents' demographic information. The questionnaire was self-developed based on prior studies and SGF 2010 and the questionnaire has been pre-tested by several practitioners and academicians as subject matter expert in order to ensure the relevance of the items. For the practitioners' awareness of Shariah audit, the current questionnaire adopted part of the questionnaire items from the studies of Kasim et al. (2009) and Mulyany (2008). The questionnaire items on the perception of the practitioners' on Shariah audit, challenges and the future implication of Shariah audit are developed after reviewing most of the relevant literature (Yaacob, 2012; Yaacob and Donglah 2012; Yaacob et al., 2013; Kasim and Sanusi, 2013; Shafii et al., 2013; Kasim et al., 2013; Najeeb and Ibrahim, 2014; Shafii et al., 2014).

Meanwhile, as for the respondents, practitioners in this study are referred to those directly involved in the control functions as stipulated in the SGF 2010. According to SGF (2010), the Shariah control functions include Shariah - audit, review, risk management and research. This study will focus only on the practitioners who are directly involved in the Shariah audit function. They were the most relevant respondents as their daily involvement in daily operations can reflect the reality of working practices. The respondents in the pre-test were instructed to assess the format of the questionnaire. Wordings in the items were not ambiguous and were relevant to the current practices.

The internal consistency of the items was assessed, and the results showed that all the items met the minimum acceptable Cronbach's alpha value of 0.7, as recommended by Nunnally (1978) and thus they were also above the value of 0.6 that is commonly accepted for exploratory studies (Litwin, 2002). Specifically, the internal consistency of the items is – perceptions of Shariah audit – 0.798, challenges of Shariah audit – 0.7 and future implications of Shariah audit – 0.62. The questionnaire was distributed to Shariah officers, internal Shariah auditors and external Shariah audit providers. The respondents (practitioners) were selected as they represented individuals who practiced and involved in daily operations and activities within the realm of Shariah control functions that fit the scope of the current study. Indeed, the respondents are relevant as they were part of three lines of defence and were expected to reflect their views or responses based on their own involvement in the real-world setting. A total of 240 questionnaires were distributed and 115 questionnaires were returned (Table 1). However, 32 of the questionnaires were excluded due to incomplete responses, resulting in 83 useable questionnaires (a 34.6% response rate). The non-response bias suggested that the late responders did not differ significantly from earlier responders which suggest that non-response bias is not a problem. In fact, self-selection bias is reduced by obtaining the responses from a different category of practitioners like internal Shariah auditors and Shariah control functions accordingly. The respondents' profiles are stipulated in Table 2.

Table 1: Response Rate

Questionnaire distribution	Total
Distributed	240
Received	(115)
Incomplete	(32)
Total usable responses	83
Response rate	34.6%

Table 2: Profile of Respondents

	Frequency n = 83	Percentage
Shariah Qualification:		
Yes	32	38.6
No	51	61.4
Organisation:		
Full Fledged Islamic Bank	12	14.4
Takaful	7	8.4
Islamic Subsidiaries	39	47.0
Consultancy, Audit Firm	25	30.1
Designation:		
Internal Shariah auditor	33	39.8
External Shariah auditor	25	30.1
Shariah officers	20	24.1
Others	5	6.0

The respondents consisted of 33 (40%) internal Shariah auditors, 25 (30%) external Shariah auditors, 20 (24%) Shariah officers and five (6%) are other respondents. Malaysia has different types of IFIs. Most (47%) of the respondents were employed by Islamic subsidiaries of local financial institutions. The remainder of the respondents is employed by external providers of Shariah audit (audit firms) (30%) and full-fledged local IFIs (14%). A total of 51 (61.4%) respondents did not have any Shariah qualifications, while the remaining 32 (38.6%) had Shariah qualifications.

4. Findings and Discussion

4.1 Practitioners' Awareness of Shariah Audit

The respondents are requested to provide the responses on the six items, adopted from Kasim et al. (2009) and Mulyany (2008) to examine their awareness of Shariah audit in Malaysia. The six items include the sources of knowing Shariah audit, party to conduct Shariah audit, qualification of Shariah auditor, scope of Shariah audit, timing of Shariah audit and appointment of Shariah auditor. Table 3 below presents the result of the awareness of Shariah audit among the respondents. The survey findings revealed that all the respondents were aware of the Shariah audit. The main source of knowledge about the Shariah audit was formal education, followed by specialised training programmes. Therefore, internal Shariah auditors are expected to respond to the development of Shariah compliance as they are expected to build up their expertise and competence in the field of Shariah audit, which may eventually lead to an overall improvement in their competencies. As stipulated in SGPD 2019, internal auditors who perform the Shariah audit function are expected to have requisite knowledge on Shariah requirements applicable to the operations of IFIs. Furthermore, Shariah auditors often constitute part of the overall internal audit function in an IFI or externally sourced. Besides, as mentioned by Ali (2018), as part of continuous development, most practitioners attend training on Shariah related courses which may simultaneously increase awareness on Shariah audit.

The finding in respect of the party performing Shariah audit indicated that Shariah audit practices in Malaysia should be dominated by internal auditors who have the requisite knowledge or Shariah qualification such as in *fiqh muamalat* as this would enable them to be truly competent Shariah auditors. In addition, the findings on qualifications also revealed that Shariah audit practices are performed by auditors who have accounting and Shariah qualifications. This is in line with the findings of Najeeb and Ibrahim (2014) and Shafii et al. (2014a), which specified the importance of both qualifications as accounting and Shariah qualifications are crucial in ensuring that auditors have a better understanding of Shariah-related issues and the risks inherent in Islamic banking transactions and operations. However, in a recent study by Ali et al. (2016) also suggested that as the industry is getting mature, it is also looking into a mixed background of qualifications. Ali (2018) felt that Shariah knowledge is something that could be acquired through hands-on jobs and continuous training on Shariah-related subjects. In fact, Khalid et al. (2018) also recommended that an in-depth knowledge of Shariah would enable the auditors to detect non-Shariah compliance activities.

In relation to the scope of the Shariah audit, it is much broader than that of a conventional audit. In line with the requirements of the SGF 2010 and SGPD 2019, the scope of a Shariah audit should cover the financial statement, people, process, product, IT system and organisational structure, as agreed by a majority of the respondents. Interestingly, none of the respondents indicated that the financial statement should be within the main scope of the Shariah audit. Shariah auditors indeed are required to examine the financial statements to ensure that recording, reporting, and disclosure on business transactions are in compliance with the Shariah principles. This raises an interesting question regarding whether practitioners feel that Shariah auditors should focus on the current or past financial statements as the latter is the main focus of external auditors.

Moreover, with regard to the independence of Shariah auditors, the majority of the respondents indicated that the Shariah audit should be performed by an external or independent party appointed by BNM or another regulatory body. Similarly, as reported by Ali (2018), the Shariah audit could be sourced from either internal sources or external providers. The source of Shariah audit is crucial as it might influence the degree of competencies and objectivity of the auditors as the external providers would be seen as more independent (as they are not being employed by the institution) and competent (due to greater exposure of the industry). Finally, in terms of the timing of the Shariah audit, the majority of respondents stated that it should be conducted all year long in order to enable the auditor to properly report any particular instances of Shariah non-compliance.

Table 3: Practitioners' Awareness of Shariah Audit

	Freq	%
Sources of knowing about Shariah audit		
Prior knowledge from reading	10	12.0
Formal education	34	41.0
Seminar attended on Islamic issues	9	10.8
Special training programme	12	14.5
All of the above	11	13.3
Others	7	8.4
Party to conduct Shariah audit		
Internal auditor under Supervision of Shariah Committee	7	8.4
Auditors with Accounting and Shariah Qualification	73	88.0
Shariah committee	3	3.6
Qualification of Shariah auditor		
Degree/professional in accounting	3	3.6
Degree/professional in *Fiqh Muamalat*	7	8.4
Degree/professional in accounting and certification in *Shariah*	69	83.1
Other Qualifications	4	4.8
Scope of Shariah audit		
Financial statement	0	0
People, process and products	16	19.0
Organizational structure	1	1.2
IT system	1	1.2
Governance	7	8.4
All of the above	58	69.9
Timing of Shariah audit		
Periodically	25	30.1
End of the financial year	8	9.6
Throughout the year	40	48.2
As it deems necessary	10	12.0
Appointment of Shariah auditor		
Stakeholders of IFIs through AGM	5	6.0
Bank Negara Malaysia	13	15.7
Shariah audit committee of IFIs	22	26.5
New established regulatory body	43	51.8

4.2 Practitioners' Perceptions of Shariah Audit

Table 4 shows the extent in which the practitioners perceived the current practice of Shariah audit. Based on the highest-ranked mean of 60.2%, most of the respondents strongly agreed that the main focus of the Shariah audit is to ensure compliance with Shariah-related issues. The respondents perceived that Shariah audit is a monitoring and control mechanism for attesting Shariah compliance in IFIs and should be given more priority (highest mean value of 3.60). This is in line with the sole objective of IFIs establishment, which is to operate on the principles of Shariah. This indicates that the Shariah audit is crucial in achieving *Maqasid al-Shariah* (gaining *falah* [success] in this world and in the hereafter) in the activities and operations of IFIs. Therefore, a Shariah audit must be conducted to realise such objective as both the auditors and the stakeholders of IFIs are continuously following a path to achieve *falah* now and in the hereafter. This finding supports the idea discussed by Abdul Rahman (2010) and Kasim et al. (2013) which stated the importance of providing assurance on Shariah compliance by the IFIs.

Adding to that, the majority of the respondents agreed that the presence of an in-house internal audit unit for Shariah audit in IFIs is crucial. This finding supports the establishment of an in-house Shariah audit function. It can be argued that an in-house internal audit function would have a better understanding of the organisational issues, culture and practices involved in such audit. Moreover, the unit could also be an internal training platform for employees and could also ensure that the issues or risks identified remained confidential. Kasim and Sanusi (2013) discussed the importance of adequate resources of Shariah auditors; however the proper structure of Shariah audit in an IFI was explored much by other studies.

Next, the majority of the respondents agreed that there are insufficient guidelines available for use in Shariah audit practices in IFIs. The practitioners also supported the statement that the present SGF has not adequately addressed Shariah audit-related issues. In fact, 67% of the respondents agreed that the current Shariah audit practices rely heavily on the conventional framework with a few modifications made by the respective auditors. These findings support those in Abdul Ghani and Abdul Rahman (2015). Comprehensive coverage of Shariah audit practices in the SGF 2010 is crucial in ensuring standardisation of practices. The respondents also perceived that due to the absence of a specific framework, the current practices of Shariah audit relies heavily on the conventional framework, which is ingrained with a capitalistic ideology. Therefore, establishing a Shariah audit framework that follows the teaching of Islam would enhance the confidence of stakeholders that the IFIs are operating within the principles of Shariah.

In the same vein, SGF 2010 and SGPD 2019 do not specify the extent or the specific areas of Shariah knowledge that should be possessed by practitioners (internal auditors) as it requires the "Shariah audit (is) to be carried out by the officers with sufficient Shariah knowledge" (BNM, 2010; BNM, 2019). Thus, these findings are in support of the idea discussed in Abdul Rahman (2014). Furthermore, Ali et al. (2016) and Ali (2018) stated that in hiring Shariah auditors, the IFIs are currently looking into mixed qualifications, such as banking, *fiqh muamalat*, and legal with greater emphasis given into accounting and Shariah. Moreover, Shariah knowledge could be enhanced through the acquisition of knowledge in Shariah-related training.

Finally, 66% of the respondents perceived that Shariah auditors are unable to perform their work independently and do not have autonomy in communicating their reports. These findings underlined the needs to re-evaluate the internal audit charter in terms of the provisions of authority, responsibility and reporting for Shariah audit practices. This finding raises concerns about the adequacy of the authority given to auditors to complete their audit work as well as the extent of their autonomy to report any issues found to those in charge with governance. The findings in Abdul Ghani and Abdul Rahman (2015) stated that the current internal audit charter does support Shariah audit practices. Table 4 summarises the practitioners' perceptions of Shariah audit.

Table 4: Practitioners' Perceptions of Shariah Audit

No	Items	SD	D	A	SA	Mean	SDev
1.	The main focus of Shariah audit is to ensure compliance with Shariah related issues	-	-	33 (39.8%)	50 (60.2%)	3.60	.492
2.	There is presence of dedicated internal Shariah audit unit in the organisation	-	5 (6.0%)	52 (62.7%)	26 (31.3%)	3.25	.560
3.	The current practice of auditing in IFIs heavily relies on a conventional framework with few modifications	4 (4.8%)	11 (13.3%)	56 (67.5%)	12 (14.5%)	2.92	.684
4.	The newly issued Shariah Governance Framework comprehensively addresses the issue of Shariah audit function.	13 (15.7%)	29 (34.9%)	33 (39.8%)	8 (9.6%)	2.43	.872
5.	Auditors are adequately trained on Shariah compliance issues to perform their function effectively.	12 (14.5%)	31 (37.3%)	32 (38.6%)	8 (9.6%)	2.43	.858
6.	There are sufficient guidelines for Shariah audit practices to be used by all IFIs	11 (13.3%)	38 (45.8%)	24 (28.9%)	10 (12.0%)	2.40	.869
7.	Shariah auditors have autonomy to exercise their functions independently	20 (24.1%)	35 (42.2%)	21 (25.3%)	7 (8.4%)	2.18	.899

SD – Strongly Disagree; D– Disagree; A– Agree; SA– Strongly Agree; SDev– Standard Deviation

4.3 Challenges of Shariah Audit

Table 5 provides the challenges of Shariah audit. The survey revealed the presence of some major challenges in the current Shariah audit practices, specifically the poor availability of competent resources, the need to improve the existing guidelines or framework and the importance of the independent positioning of an internal audit unit in presenting its report.

The practice of Shariah audit in Malaysia is affected by a shortage of qualified Shariah auditors in terms of competency, expertise and proper Shariah qualifications. This finding is in congruence with a study conducted by PwC (2011), which showed that there is a dire need to increase the number of competent and knowledgeable Shariah auditors in Malaysia. Moreover, Ali et al. (2016) and Najeeb and Ibrahim (2014) highlighted the importance of competency requirements between Shariah qualified and non-Shariah qualified auditors.

The findings highlighted some of the challenges that could weaken Shariah audit practices, including the absence of a standalone Shariah audit framework and the absence of specific standards and guidelines for external and internal providers of Shariah audit. These findings are in line with Abdul Rahman (2010), Abdul Rahman (2014), Haniffa (2010), Kasim and Sanusi (2013), Kasim et al. (2009), Shafii et al. (2010), Shafii et al. (2013) and Yaacob (2012). There is a need for proper guidelines for effective implementation of independence and competency requirements. The lack of standardised requirements reduces consistency and makes it more difficult to measure and compare the quality of the internal and external providers of the Shariah audit.

Moreover, on the issue of independence, the respondents perceived that their function of 'providing independent assessment and objective assurance to value-add and improve IFIs' compliance with Shariah' could be violated. The respondents perceived that being internally attached to the organisations may increase self-review or familiarity threats. The absence of proper guidance on the structure of Shariah audit as well as the absence of specific Shariah audit charter could lead to the issue of independence in reporting findings of the audit report. This could influence the quality of the audit reports issued to those in charge with governance. In fact, the findings in the audit reports could have an influence on the management. Perhaps, the current Shariah audit practices may improve on its autonomy in order to exercise independence.

Table 5: Challenges of Shariah Audit

No	Items	SD	D	A	SA	Mean	SDev
1.	Inadequate competent and well-trained personnel to execute Shariah audit function is a great threat to IFIs integrity	-	6 (7.2%)	53 (63.9%)	24 (28.9%)	3.22	.564
2.	Absence of independent framework for Shariah audit in IFIs affects its proper implementation	1 (1.2%)	11 (13.3%)	53 (63.9%)	18 (21.7%)	3.06	.631
3.	Closer scrutiny of the SGF indicates that the Framework has shown less emphasis in providing explanations of the competency requirements and the desired functions of Shariah audit	2 (2.4%)	8 (9.6%)	62 (74.7%)	11 (13.3%)	2.99	.574
4.	Absence of specific Shariah audit standard either from external auditing or internal auditing hinders effective practice of Shariah audit function	10 (12.0%)	11 (13.3%)	51 (61.4%)	11 (13.3%)	2.76	.835
5.	Internal audit unit of IFIs discloses an independent Shariah audit report.	10 (12.0%)	34 (41.0%)	26 (31.3%)	13 (15.7%)	2.51	.902

SD – Strongly Disagree; D– Disagree; A– Agree; SA– Strongly Agree; SDev– Standard Deviation

4.4 Future Implications of Shariah Audit

Table 6 presents the future implications of Shariah audit. The findings revealed the need to have an academic programme at a higher educational level in order to produce human resources with the required knowledge and skills to perform the Shariah audit function, supporting the idea discussed in Abdul Rahman (2010) and Abdul Rahman (2014). The provision of a standalone programme or the integration of a Shariah audit course into existing accounting programmes could provide an avenue for producing knowledgeable and competent practitioners, as reported by Najeeb and Ibrahim (2014). Definitely, high-calibre Shariah audit practitioners would help to improve the credibility of Shariah compliance and accountability in the activities and operations of IFIs. In addition, such programmes would supply the appropriate human resources required by the IFIs as well. Hence, the confidence of stakeholders, customers and the general public would improve substantially, as the current system is dominated by practitioners with inadequate Shariah certification may hamper for the effective practice of Shariah audit.

The findings also illustrated that making the Shariah audit a profession through the establishment of a separate regulatory/professional body would enhance the capacity to employ 'the right type of people' as practitioners. Moreover, to increase the greater number of competent Shariah auditors, immediate attention for a future pool of resources with the help of higher learning institutions and higher recognition through the introduction of professional certification is highly demanded. Furthermore, it is important to ensure that on-going or continuous professional development or education is provided to help auditors keep up with changes or developments in the industry. Employability skills should be one of the key criteria for employment as a Shariah audit practitioner in an IFI.

The majority of the respondents agreed that there is a need for a more comprehensive audit framework in order to ensure that there is a standardisation of Shariah audit practices between external and internal providers in the future. This would also simplify the assessment of the performance of auditors based on either a ranked or star system. In fact, a comprehensive Shariah audit framework and standard guidelines would make IFIs entirely different from their conventional counterparts as they would follow Shariah requirements in all their dealings and work independently towards satisfying the purpose of their existence. In addition, the availability of standards and guidelines would provide clear criteria for entry into the Shariah audit profession, thereby harmonising the practice as well as bringing practitioners into a professional cadre.

Attaining these goals would enhance and preserve the confidence of the various IFI stakeholders that the operations and activities of the IFIs are in line with the principle of Shariah. Furthermore, the findings of this study demonstrated the need to establish a new regulatory/professional authority, separated from the BNM, to oversee Shariah audit practices. This new authority could be in charge with regulating the profession, services, ethical conduct and welfare of its members. This authority could also enhance the performance of practitioners and promote healthy competition among the IFIs in rendering excellent Shariah-compliant services, in line with Najeeb and Ibrahim (2014) and Shafii et al. (2014a). Finally, the provision of standard guidelines and a framework, as well as the establishment of an independent professional body to oversee the activities of IFIs would make Shariah audit more of a profession, in line with other professions, and these practitioners would have adequate scope and autonomy to discharge their functions diligently with professionalism.

Table 6: Future Implications of Shariah Audit

No	Items	SD	D	A	SA	Mean	SDev
1.	Competence of Shariah audit practitioners could be improved through training, workshops, seminars and others alike	-	1 (1%)	46 (55%)	36 (44%)	3.42	.521
2.	The potentials of Shariah audit as a marketable career in the near future are very bright	-	3 (4%)	52 (62%)	28 (34%)	3.30	.535
3.	Offering academic programme in higher learning institutions on Shariah audit could help in providing educated Shariah auditors	-	2 (2%)	54 (65%)	27 (33%)	3.30	.512
4.	A professional body in charge of Shariah auditing should be established and given the responsibility of issuing professional certificate just like ACCA and CIA	-	5 (6%)	52 (63%)	26 (31%)	3.25	.560
5.	Future of Shariah audit depends heavily on a comprehensive Shariah audit framework and standard guidelines to be used in its practice	-	9 (11%)	58 (70%)	16 (19%)	3.08	.546
6.	To achieve uniformity, the performance of IFIs based on Shariah compliance should be ranked by using a (3-star system***)	3 (4%)	11 (13%)	59 (71%)	10 (12%)	2.92	.629
7.	The current practice of Shariah audit in Malaysia signifies that the future of Shariah audit is at stake	11 (13%)	38 (46%)	33 (40%)	1 (1%)	2.29	.708

SD – Strongly Disagree; D– Disagree; A– Agree; SA– Strongly Agree; SDev– Standard Deviation

5. Conclusion

The role of Shariah audit is to uphold Shariah principles and values and to ensure the compliance of IFIs' operations in offering Shariah-compliant services. The monitoring activities of Shariah audit are intended to safeguard the interests of the stakeholders of IFIs, namely account holders, shareholders, creditors, management and employees as well as the community at large. Shariah audit ensures that there is an adequate mechanism of checks and balances in place that is tailored to the objectives and missions of its establishment as per the *Maqasid al-Shariah* (Yaacob and Donglah, 2012).

This study examined practitioners' perceptions on the extent of the current Shariah audit practice in Malaysia several years after the implementation of the SGF 2010. The diversity of practitioners as the respondent is considered as part of theoretical contribution since limited studies applied similar respondents. Being those in charge of control functions in Shariah governance, they are most relevant due to their daily involvement in the reality of working practices. The findings showed that there is a dire need to establish a standalone Shariah audit framework to cater for the increasing number of IFIs in Malaysia. The findings also revealed that relevant qualifications apart from Shariah knowledge for the said function are greatly needed to be improved. Hence, this study will help practitioners to understand the type of competencies and qualifications that are expected of them. Then, hopefully, Shariah audit will be developed to the professional level just like its counterpart, conventional audit. The study also provided an insight in terms of the role that the educational sector can play in integrating Shariah audit into the auditing curriculum, a step that is long overdue. Moreover, the findings of this study drew attention to some emerging issues and challenges in current Shariah audit practices. Particularly, the Shariah audit should strengthen its independence through approved functional reporting and autonomy, which should be stated clearly in the internal audit charter. This is crucial as it would influence the extent of the authority and autonomy of Shariah auditors in conducting audit work as well as in reporting their audit findings. In addition, IFIs also need to reassess the needs to establish a designated internal audit unit and capitalise on it as part of the internal training platform for their employees.

Some practical implications are offered that might be considered by relevant authorities and other stakeholders involved in making policies to uphold and protect the integrity of this emerging profession in order to safeguard its future. First, financial statements being part of the Shariah scope should be emphasised further as Shariah compliance aspects may not be considered by the internal or external auditors in its routine financial statement audit. Second, the presence of Shariah auditors is greatly needed; however, the best structure or model of Shariah audit activity would greatly depend on the needs and capacity of the respective IFI. The selected model may determine the extent of its independence and competencies. Third, the establishment of the Shariah audit framework would standardise the practices and ensure the quality of work performed by either internal or external providers.

Moving forward, in order to upgrade Shariah audit practices, priority should be given to the 1) provision of a standalone Shariah audit framework to complement the requirements of SGF 2010 and SGPD 2019; 2) providing proper Shariah guidelines and procedures for auditing; 3) establishing a separate regulatory/professional body to oversee the activities of IFIs; 4) offering an approved academic programme on Shariah audit as a course like other courses in institutions of higher learning or integrating Shariah audit into existing auditing programmes; 5) organising regular workshops, seminars, and training for both potential and existing Shariah auditors; 6) setting up a professional body similar in form of other professional bodies like the Association of Chartered Certified Accountants (ACCA) and Certified Internal Auditors (CIA by IIA), as suggested by Najeeb and Ibrahim (2014), where this professional body is given the responsibility to offer a professional certificate in Shariah audit; and finally, 7) revisiting the terms and references within the internal audit charter and its structure in respect of Shariah audit practices.

It should be noted that the findings and conclusions drawn in this study are subject to several limitations in respect of the respondent selection procedure, descriptive statistics and questionnaire survey used. Thus, future studies could cover the same group of respondents but using an interview or mixed-mode method (questionnaire, interview, and document review) in order to fully gauge practitioners' perceptions of Shariah audit practices. Moreover, a document review could contribute to a more in-depth understanding of the actual practices adopted by internal and external providers of the Shariah audit in Malaysia. In addition, future research could explore the suitable model of Shariah audit that is highly recommended given the specific context of the IFIs as well as the extent of coverage on Shariah audit practices in internal audit charter.

References

Abdul Ghani, N. L., & Abdul Rahman, A. R. (2015). An analysis of Shariah audit practices in Islamic banks in Malaysia. *Jurnal Pengurusan, 43*(1), 107-118.

Abdul Ghani, N. L., Ariffin, N. M., & Rahman, A. R. A. (2019). The measurement of effective internal Shariah audit function in Islamic financial institutions. *International Journal of Economics, Management and Accounting*, *27*(1), 141-165.

Abdul Rahman, A. R. (2008). Shariah audit for Islamic financial services: the needs and challenges. *ISRA Islamic Finance Seminar, 11*, 1-14.

Abdul Rahman, A. R. (2010). Shariah audit for Islamic financial services: the needs and challenges. *The Journal of Muamalat and Islamic Finance Research, 7*(1), 133–145.

Abdul Rahman, A. R. (2014). Shariah audit: from compliance to assurance. Islamic Accounting Symposium, 27-28 August 2014. Jakarta.

Abdullah, D. V., & Pillai, R. (2010). Procedures for reporting financial risk in Islamic finance. Islamic finance: Instruments and markets. *QFinance*, 45-48.

Alahmadi, H. A., Hassan, A. F., Karbhari, Y., & Nahar, H. S. (2017). Unravelling Shariah audit practice in Saudi Islamic banks. *International Journal of Economic Research*, *14*(15), 255-269.

Alam, T., Hassan, T., & Ferdous, K. (2017). Competency of Shariah auditors: issues and challenges in Pakistan. *Journal of Internet Banking and Commerce*, *22*(2), 1-12.

Alamgir, M. (2014). An analysis of Islamic banking activities in Bangladesh: issues and challenges. *Thoughts on Economics*, 25(3 & 4), 29-58.

Ali, N. A. M., Mohamed, Z. M., Shahimi, S., & Shafii, Z. (2015). Competency of Shariah auditors in Malaysia: Issues and challenges. *Journal of Islamic Finance, 22*(30), 1-9.

Ali, S. A., Hassan, A., & Omer, A. (2017). Exploring the impact of Shariah training on Islamic banking employees in Pakistan. *Journal of Islamic Banking and Finance, 34*(2), 24-43.

Ali, N. A. M. (2018). Challenges in recruiting specialized internal auditors: Case study evidence of Islamic financial institution in Malaysia. *International Journal of Academic Research in Business and Social Sciences, 8*(1), 60-74.

Ali, N. A. M., Mohamed, Z. M., Shahimi, S., & Shafii, Z. (2016). Knowledge for Shariah auditors' competency in Islamic financial institutions. *International Journal of Trade, Economics and Finance, 7*(4), 113-120.

Arman, S. M. (2013). Shariah compliance features of Islamic financial institutions and its challenges. *Arabian Journal of Business and Management Review (Oman Chapter), 3*(4), 91-98.

Arwani, A. (2018). Issues and challenges of Shariah auditing in Islamic financial institution and corporate governance compliance. *Media Riset Akuntansi, Auditing and Informasi, 18*(2), 169-186.

Bank Negara Malaysia (BNM) (2010). *Shariah* G*overnance Framework for Islamic financial institutions*. Kuala Lumpur: Bank Negara Malaysia.

Bank Negara Malaysia (BNM) (2013). *Islamic Financial Services Act 2013*. Kuala Lumpur: Bank Negara Malaysia.

Bank Negara Malaysia (BNM) (2018). *Operational risk integrated online network (ORION) policy document*. Kuala Lumpur: Bank Negara Malaysia.

Bank Negara Malaysia (BNM) (2019). *Shariah governance policy document*. Kuala Lumpur: Bank Negara Malaysia.

Chapra, M. U., & Ahmed, H. (2002). *Corporate governance in Islamic financial institutions*. Jeddah: IRTI.

Dar, H., Rahman, R., Malik, R., & Kamal, A. A. (Eds.). (2012). *Global Islamic Finance Report: GIFR 2012*. Edbiz Consulting Publication.

Goodhart, C. (2011). *The Basel Committee on Banking Supervision*. New York: Cambridge University Press.

Grassa, R., & Matoussi, H. (2014). Corporate governance of Islamic banks: A comparative study between GCC and Southeast Asia countries. *International Journal of Islamic and Middle Eastern Finance and Management, 7*(3), 346-362.

Hameed, S. (2000). *The need for Islamic Accounting: Perception of Its Objectives and Characteristics by Malaysia Accountants and Academics*. (Unpublished doctoral dissertation). University of Dundee, Scotland, United Kingdom.

Haneef, M. A. M. (1997). The Islamic worldview and Islamic economics. *IIUM Journal of Economics and Management, 5*, 39-65.

Haniffa, R. (2010). Auditing Islamic financial institutions. Islamic finance: Instrument and market. *QFinance*. UK: Bloomsbury Information Limited.

Islamic Financial Services Board, (2009). *IFSB 10 Shariah Governance Systems.* Kuala Lumpur: Islamic Financial Services Board.

The Institute of Internal Auditors (IIA). (2013). *IIA Position Paper: The Three Line of Defense in Effective Risk Management and Control*. Florida: The Institute of Internal Auditors.

Kasim, N. (2010). Auditing from the Islamic perspective. *Accountants Today,* 28–31.

Kasim, N., Htay, S. N. N., & Salman, S. A. (2016). Empowering the Shariah committee towards strengthening *Shariah* governance practices in Islamic financial institutions. *Review of European Studies, 8*(2), 142-148.

Kasim, N., Ibrahim, M., Hameed, S., & Sulaiman, M. (2009). Shariah auditing in Islamic financial institutions: Exploring the gap between the 'desirable' and the 'actual'. *Global Economy and Finance Journal, 2*(2), 127-137.

Kamaruddin, M. I. H., & Hanefah, M. M. (2017). Enhancing Shariah audit practices in Islamic financial institutions in Malaysia. *Journal of Modern Accounting and Auditing, 13*(11), 457-470.

Kasim, N., & Sanusi, Z. M. (2013). Emerging issues for auditing in Islamic financial institutions: Empirical evidence from Malaysia. *IOSR Journal of Business and Management, 8*(5), 10-17.

Kasim, N., Sanusi, Z. M., Mutamimah, T., & Handoyo, S. (2013). Assessing the current practice of auditing in Islamic financial institutions in Malaysia and Indonesia. *International Journal of Trade, Economics and Finance, 4*(6), 414.

Khalid, A. A. (2020). Role of audit and governance committee for internal Shariah audit effectiveness in Islamic banks. *Asian Journal of Accounting Research*, *5*(1), 81-89.

Khalid, A. A., Haron, H., & Masron, T. A. (2017). Relationship between internal Shariah audit characteristics and its effectiveness. *Humanomics, 33*(2), 221-238.

Khalid, A. A., Haron, H., Sarea, A. M., & Masron, T. A. (2018). The role of Shariah supervisory board on internal Shariah audit effectiveness: Evidence from Bahrain. *Academy of Accounting and Financial Studies Journal, 22*(5), 1-15.

Litwin, M. S. (2002). *How to assess and interpret psychometrics*. Thousands Oak, California: Sage Publication.

Muhamad, S. F., & Sulong, Z. (2019). Corporate and Shariah governance mechanisms and earnings quality in Islamic banks: A review and evaluation of patterns. *Islamic Development Management,* 19-31. Singapore: Springer Nature Singapore.

Mulyany, R. (2008). *Shariah audit for Islamic financial institutions: Perceptions of accounting academicians, audit practitioners and Shariah scholars in Malaysia*. Unpublished Master thesis, Kulliyyah of Economics and Management Sciences, International Islamic University Malaysia.

Nahar, H. S., & Yaacob, H. (2011). Accountability in the sacred context. *Journal of Islamic Accounting and Business Research, 2*(2), 87.

Najeeb, S. F., & Ibrahim, S. H. M. (2014). Professionalizing the role of Shariah auditors: How Malaysia can generate economic benefits. *Pacific-Basin Finance Journal, 28*, 91-109.

Nunnally, J. C. (1978). *Psychometric theory* (2nd ed.). New York: McGraw-Hill.

Othman, R., & Ameer, R. (2015). Conceptualizing the duties and roles of auditors in Islamic financial institutions: What makes them different?, *Humanomics, 31*(2), 201-213.

Puad, N. A. M., Rafdi, N. J., Shukeri, S.N., & Rashid, N. J. R. (2015). Analysis of Shariah audit/review report: Malaysia, Pakistan and Bahrain. Proceeding of the 2nd International Conference on Management and Muamalah. Bangi, Malaysia.

PricewaterhouseCoopers (PwC). (2011). *Shariah audit: Industry insight*. PwC Report.

Shafii, Z., Abidin, A. Z., Salleh, S., Jusoff, K., & Kasim, N. (2013). Post implementation of Shariah governance framework: The impact of Shariah audit function towards the role of Shariah Committee. *Middle East Journal of Scientific Research, 13*(Special issue), 7-11.

Shafii, Z., Ali, N. A. M., & Kasim, N. (2014a). Shariah audit in Islamic banks: An insight to the future *Shariah* auditor labor market in Malaysia. *Procedia-Social and Behavioral Sciences, 145*, 158-172.

Shafii, Z., Salleh, S., Zakaria, N., Hanefah, M. M., Ali, N. A. M., & Yunanda, R. A. (2014b). Shariah audit certification contents: Views of regulators, Shariah committee, Shariah reviewers and undergraduate students. *International Journal of Economics and Finance, 6*(5), 210-219.

Shafii, Z., Ali, N. A. M., Mohamed, Z. M., & Shahimi, S. (2015a). Competency of Shariah auditors in Malaysia: Issues and challenges. *Journal of Islamic Finance, 4*(1), 22-30.

Shafii, Z., Abidin, A. Z., & Salleh, S. (2015b). Integrated internal-external Shariah audit model: A proposal towards the enhancement of Shariah assurance practices in Islamic financial institutions. Working Papers (1436-7), *The Islamic Research and Teaching Institute (IRTI).*

Shafii, Z., & Salleh, S. (2010). Enhancing governance, accountability and transparency in Islamic financial institutions: an examination into the audit of Shariah internal control system. *Malaysian Accounting Review, 9*(2), 23-42.

Shafii, Z., Salleh, S., & Shahwan, S. (2010). Management of Shariah non-compliance audit risk in the Islamic financial institutions via development of Shariah compliance audit framework and Shariah audit programme. *Kyoto Bulletin of Islamic Area Studies, 3*(2), 3-16.

Shaharuddin, A. (2011). Shariah governance of Malaysian Islamic banking institutions. *Jurnal Ekonomi, 14*(2), 53-57.

Sultan, S. A. M. (2007). *A mini guide to Shariah audit for Islamic financial institutions-a primer*. CERT Publications Sdn. Bhd.

Yaacob, H., & Donglah, N. K. (2012). *Shariah* audit in Islamic financial institutions: the postgraduates' perspective. *International Journal of Economics and Finance, 4*, 224-239.

Yaacob, H. (2012). Issues and challenges of Shariah audit in Islamic financial institutions: a contemporary view. Proceeding of 3rd International Conference on Business and Economic Research, 3rd October 2012. 2669-2679.

Yaacob, H., Shafeek, F., & Nahar, H. S. (2013). Exploring undergraduate students' understanding of Shariah based audit: Implications for the future of Shariah auditing labor market in Brunei. *Asian Journal of Finance & Accounting*, *5*(2), 84–100.

Yasoa, M. R., Abdullah, W. A. W., & Endut, W. A. (2018). Shariah audit effectiveness in Islamic banks: A conceptual framework. *Auditing, 2*(10), 12-19.

Yussof, S. A. (2013). Prospects of a Shariah audit framework for Islamic financial institutions in Malaysia. *Islam and Civilisational Renewal, 4*(1), 80-102.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 59-69
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

The Contemporary Role of Tabung Haji Malaysia in Fulfilling Sustainability via Islamic Social Finance

Noor Mahinar Abu Bakar[a*], Norhashimah Mohd Yasin[b], Noor Hainiakmal Abu Bakar[c]

[a,b] *Ahmad Ibrahim Kulliyyah of Law, International Islamic University Malaysia*
[c] *INCEIF, Kuala Lumpur, Malaysia*

[*]*Corresponding author: mahinarab@yahoo.com*

Abstract

As an Islamic institution, Tabung Haji (TH) Malaysia is important in mobilising savings of depositors and operating innovative Islamic investment fund in an efficient manner thereby fulfilling the lifelong desire of Muslims in embarking their pilgrimage journey and performing *hajj* rituals. The positive impact of TH on Muslim society in Malaysia is undeniable. However, problems have been brewing in TH when in 2015 the Central Bank of Malaysia issued a warning to TH on their negative reserves but still paid out higher dividends and in 2018 the new management of TH made police reports on the 2017 financial accounts alleging that the previous management misused fund, broken their own accounting rules, and illegally declared dividends. This paper undertakes to examine the history, objectives and sustainable strategies of TH that ensures its long term survival, resilience and contribution to Islamic Social Finance (ISF). This study uses qualitative library research method that specifically refers to financial reports (2010-2018), documents, journals and texts regarding activities of TH and authors' own observation, to test how TH adapts to the new setup of Covid-19 (C19) challenges via ISF. This study reveals that although TH provides a good example as a competent *hajj* agency worldwide unethical political and external interference on professional management and decision-making of TH has brought undue pressures on TH to make politically-motivated decisions resulting in a conflict of interests. This study suggests that in times of C19 new landscape, TH should lead in ISF, reinvent TH as an effective post pandemic organisation and adopting purposeful technologies for business survival. This study has important implications on business goals and relevance of TH if they are to enhance their image and contributes to sustainable development of ISF.

Keywords: Islamic social finance, Tabung Haji, post Covid-19, sustainable development, Malaysia

1. Introduction

The COVID-19 (C19) pandemic has created immense human suffering while also sparked worldwide action from the global community and individuals eager to help the diverse set of stakeholders. As for the annual *hajj* pilgrimage this year (2020), Saudi Arabia imposed strict restrictions to allow a limited number of pilgrims only to those residing within the country. Many countries also announced *hajj* cancellation, barring their citizens to attend *hajj* or advising them to skip the *hajj* due to the C19 pandemic. This is a time for TH to help tackle and respond the devastation of C19 in *hajj* management in ensuring the future pilgrims are safe and the Malaysian pilgrimage industry remains sustainable, as well as mobilising finance for humanitarian assistance. TH has the tools for C19 response and stands ready to help communities unlock the alternative instruments to respond to C19 pandemic. As an Islamic institution, TH can be part of the C19 response and recovery through a range of "Islamic Social Finance" (ISF) instruments well-suited for social impact and fulfilling national sustainability in the long term.

The term "Islamic Social Finance" or ISF refers to the tools of finance that are rooted in the Islamic ethics and intended for social good (Jouti, 2019). According to Jouti these tools include: Islamic traditional philanthropic instruments like zakat (almsgiving), sadaqah (charity), waqf (endowments), and cooperation

Article history:
Received 5 November 2020
Revised 10 December 2020
Accepted 12 December 2020

based foundations of *qard hasan* (interest-free loan) as well as *kafalah*. The scope of ISF has been extended beyond the traditional instruments which also covers the contemporary Islamic microfinance institutions like sukuk and takaful for social benefit (Azman and Engku Ali, 2019). Innovative instruments like sukuk not only leads to long-term social improvements, long-term resilience, is an adaptive capacity-building for communities at risk, but also empowers communities to recover more strongly from shock while facilitating social and economic inclusion within their populations (Madani, 2016).

Focusing on TH and ISF, this study explored the underlying history, objectives, strategies of TH and its critical role in applying the modes of ISF towards socio-economic development and sustainability of Malaysia. The findings in this study show that TH is viewed internationally as one of the most successful experiments in *hajj* management of the Muslim ummah. Also, domestically has become one of the main Islamic institutions of Malaysian Islamic finance and has contributed to the sustainable impact on Malaysian socio-economy, particularly in ensuring the welfare of the pilgrims as well as the Muslim community. However, unethical political and external interference on professional management and decision-making of TH has brought undue pressures on TH to make politically-motivated decisions resulting in a conflict of interests. This paper has important implications on business goals and relevance of TH that ensures its long term survival, resilience and contribution via ISF if they are to enhance their image and sustain socio-economic development post C19 pandemic. Some of the success factors of TH can also serve as guidelines and lessons for other countries to follow.

This study is organised in six main sections including section one as the introduction. Section two presents the review of literature, three on methodology of the research, and four discusses the practices of ISF and its modes in TH. Subsequently, the impact and achievements of TH in implementing ISF for socio-economic development and sustainability including governance in Islamic institution is analysed and discussed in section five. Finally, section six recommends and concludes this study.

2. Literature Review

The history of Islamic banking in Malaysia can be traced back to the introduction of TH which is a special purpose institution in 1963, whereby the success of TH subsequently encouraged the Malaysian government to establish Malaysian first full-fledged Islamic bank on 1st July 1983, Bank Islam Malaysia Berhad (Alamad, 2019). However, the emergence of Islamic financial institution (IFI) in Malaysia is quite recent which can be categorised into banking and non-banking intermediaries (Yusuf, 2011). As a premier IFI, TH has come up with products that assure the two primary needs of human: religious by providing facilities during pilgrimage and financial when savings are mobilised to *riba* free investments (Baig, 2016). As the world’s first and oldest IFI in modern times, TH had flourished and impacted the Muslim Malaysian society with its involvement in *muamalat* activities and *ibadah* activities in being responsible to ensure the welfare of the pilgrims (Zandi et al., 2017). The significance of TH can be seen through the increase in number of total pilgrims for many years now, and that its Corporate Social Responsibility (CSR) programmes are an important element for TH to contribute back and share its success with the Muslim community (Ismail, 2020). It was through CSR that TH give back to the community by implementing various social responsibility programme focusing on *hajj*, education, entrepreneurship and community welfare (Ibrahim et al, 2020).TH has its roots in the community and clear structure as a pilgrimage saving fund which pool funds of future *hajj* pilgrims, and therefore it benefits a lot from the Muslim depositors who choose Tabung Haji to save in (Mansoro, 2020).

As TH strife towards providing excellent *hajj* services to Malaysian pilgrims, depository services and investment, the ISF provides innovative options to help mobilise these efforts (Muheramtohadi, 2019). As a social and international faith-based financing, the ISF has been an additional source of financing that better leveraged human suffering and vulnerability (Madani, 2016). The tools of ISF is conceptualised from the fundamental values of *tawhid* (oneness of Allah) paradigm that justice entails giving individuals what belongs to them with “integrity, rigor and insight” and *maqaṣid al-Shariah* (objectives of Shariah) in Islamic finance whereby the management is driven to impact life of the society (Cattelan, 2018). Throughout the history of Islam, the ISF institutions as proposed by the Shariah law have always played a pivotal role of sustaining socio-economic development and efficiency of Muslim society (Abojeib and Habib, 2019). ISF has a huge potential to enhance the Islamic economy eco-system for social benefits but steps must be taken to cushion the regulatory issues related to the application of ISF instruments in Malaysia (Haseeb, 2018). In this regard, a smart partnership between key stakeholders such as the federal government, Islamic religious councils, non-governmental organisations (NGOs), Islamic financial institutions, fund managers and private companies is crucial (Mansor et al., 2018).

3. Methodology

This study presents a conceptual framework based on qualitative library research method and literature review that specifically refers to data collected from financial reports of TH (2012-2019), documents, peer-reviewed journals and texts regarding activities of TH and authors' own observation, to test how TH adapts to the new setup of Covid-19 challenges. This study analysed the contemporary role of TH in implementing ISF towards building a sustainable socio-economic ecosystems of Muslims in Malaysia post Covid-19.

4. Findings

TH has taken various progressive steps to invigorate and revitalise ISF instruments like waqf, zakat, sukuk, and takaful to effectively support the sustainable future provided the instruments are developed properly, managed and utilised with transparency, accountability and efficiency. This sub-section analyses the performance of ISF by TH from 2010 to 2019 in wealth distribution to various stakeholders.

4.1 Background of TH Malaysia

Previously, Malaysian pilgrims especially from rural areas used traditional methods to save money in pillows, earthen jar or under floors and some even sold their livestock or properties to cover their expenses for pilgrimage to the Holy Land of Mecca. However, these traditional savings methods are detrimental to the rural and urban economy of Malaysia. The idea about TH as an Islamic institution with Shariah based fund management was inspired by the late Royal Professor Ungku Aziz bin Ungku Abdul Hamid with the aim for Malaysians to save money for *hajj* but also as an Islamic institutional fund that invests according to the Islamic law and achieve a savings system that avoid *riba* as compared to the conventional banks (Husseini et al., 2019). In August 1962, the "Pilgrims Savings Corporation" was incorporated and subsequently launched on 30 September, 1963 and in 1969 the Corporation has merged with the Pilgrims Affairs Office (operated in Penang since 1951) giving birth to the "Pilgrims Management and Fund Board" under the Pilgrims Management and Fund Board Act 1969.

TH is a state-owned and government-backed pilgrimage fund that manages more than 80% of Malaysia *hajj* pilgrims every year with the total number of pilgrims increasing over the years, signifying its role and importance in the socio-economic life of Muslims in Malaysia (Ismail, 2020). It is a statutory body by the name of "Lembaga Tabung Haji" (LTH) or the "Pilgrims' Management and Fund Board of Malaysia" and governed by the Tabung Haji Act 1995 (Part II section 3(1)) which was previously known as the Lembaga Urusan dan Tabung Haji Act of 1969 (Tahir and Abidin, 2017). The LTH of Malaysia which was popularly known as "Tabung Haji" (TH), was the first Islamic investment company established in 1962 to help fund pilgrimage activities of the Malaysian Muslim community (Alamad, 2019). As the pioneer of an Islamic non-bank financial institution in Malaysia, the success of TH has paved the way for the establishment of the first full-fledged Islamic bank in Malaysia with TH being one of the major shareholders of the bank through its shareholdings in BIMB Holdings Berhad (Haneef and Tahir, 2018). The TH Act states the main activities of TH among others, is "to administer all matters concerning the welfare of pilgrims and to formulate policies in connection therewith" such as *hajj* management, depository services and investment. It has more than 50 years of experience in savings, *hajj* services and investments, and is the nation's largest Islamic fund manager with more than RM75 billion funds as at 31 December 2018 (TH Annual Report, 2018). Previously, TH was solely governed by the TH Act 1995 and that Bank Negara Malaysia (BNM) has no regulatory oversight of TH, but as at January 2019 TH be placed under the supervision of BNM (Ahmad, 2018a).

Started as a savings and investment institution, TH has now grown to become a big specialised financial house, financing various projects within and outside Malaysia (Yusuf et al., 2016). As a savings corporation, TH applies the deposit contract of *wadiah yad dhamanah* (safe keeping with guarantee) (Habibullah et al., 2017). Section 16(1) of TH Act allows the receipt of deposits from Muslim individuals of Malaysian citizenship and foreigners residing in Malaysia for the purposes of: "(a) saving towards pilgrimage to the Holy Land; or (b) as savings for investment or other purposes permitted by TH" (Sect 16(2)). TH has since flourished and currently it has 125 branches with more than 10,000 touch-points nationwide as well as an office in Jeddah, Kingdom of Saudi Arabia under the purview of the Malaysian Consulate. As at the end of 2018, TH has managed more than 9 million depositors and depositors' fund has increased by 41% since 2011 to a total savings of more than US $180 billion or RM 75.4 billion (TH Annual Report, 2018). In 2018, TH recorded a net asset of RM75.7 million which is more than 42% increase than 2011 (Table 1). According to Ishak (2011), TH has grown tremendously since 1963 where started with 1,281 savers with a total savings of US $15,400 through three branch offices, and at the end of 2009 TH managed more than 5 million savers; 26,000 pilgrims through five airports in Malaysia. Table 1 shows the total of deposits received by TH, number of depositors, revenue and net asset of TH.

Table 1: TH Deposits, Revenue and Net Assets (2010 - 2018)

Years	Deposits Received (RM Billion)	Number of Depositors (Million people)	Revenue (RM Billion)	Net Asset (RM Million)
2010	27,115	5,627	2,056	28,289
2011	31,694	6,956	2,176	32,036
2012	38,284	8,171	2,832	40,125
2013	45,719	8,304	3,730	48,169
2014	54,358	8,610	3,289	54,006
2015	62,548	8,850	4,467	59,462
2016	67,704	9,080	3,481	63,573
2017	73,522	9,270	4,585	69,380
2018	75,412	9,210	4,229	75,769

Source: Compilation of TH Annual Reports 2010-2018

TH continues to operate to the present day with lots of improvements and diverse operational activities for social good. For example, the CSR programme of TH which is in line with Islamic values, is seen as an important roadmap for TH in contributing back to the community and share its success with the Muslim community. CSR is a responsibility of business organization to work and contribute towards social betterment (Geva, 2008). CSR does not emphasize on Shariah principles nor sustainability in the emerging market but rather an organizational effort towards compliance, reputation and fulfilling requirements by respective stakeholders (Azam et al., 2019). TH's CSR which is based on their past year performance rather than in the emerging market, has implemented its CSR programme with emphasising on the "four pillars of marketplace, community, workplace and environment which include: *hajj* subsidy, maintaining low *hajj* payment, collaborate with Bumiputra Muslim suppliers and contractors in key TH projects, contributes hemodialysis machines to Government hospitals, increase membership in Kelab Taha and Taha@U membership to total more than one million teenagers nationwide, human capital development courses and service excellence training for staff, and environmental awareness campaign for staff" (TH Annual Report, 2013).

To facilitate savings for the pilgrimage to Mecca, TH through its subsidiaries invests in Shariah-compliant platforms. TH's group subsidiaries include: plantation, financial institution, information technology, hospitality, services, as well as property development and construction. To reflect TH's risk-appetite when managing its group performance, in 2018 a new "Strategic Asset Allocation" (SAA) was revised to ensure favourable returns, rebalance asset management to maintain acceptable yield, and make depositors' interest as top priority. Thus, its investment is based on a balanced risk exposure via a strong credit standing financial instruments with stable-income model. As for equity investment, a more robust risk management policy like cut-loss policy was introduced to minimise any downside risk of under-performed equity. In addition, to keep pace with the fast-evolving Islamic banking and finance industry, TH's finance sector of BIMB Holdings Berhad has remained resilient in exploring new innovative financial solutions while embracing transformation. Moreover, the long-term strategies of TH Properties Group of diversifying income sources via business expansion in the global property development market, build properties and facilities for business management. Such strategies have been successful when in 2018 the TH property development and construction sector recorded commendable financial performance even with the global economy and property market was down. Meanwhile, TH hospitality sector remains profitable via contributions from the Travel and Services Sdn Bhd being the leading provider of international Islamic travel package. Moreover, TH's information and communication technology sector via Theta Edge Group continued their involvement in provisioning engineering services such as fiberisation, operations and maintenance works to telecommunication sector.

However, the plantation sector, TH Plantation (THP) remains the biggest challenge for TH due to Europe negative campaign on palm oil which contributes to lower demand for crude palm oil (CPO), sliding prices, and low fresh fruit bunches harvest. In 2012, THP issued RM1 billion sukuk *murabahah* (maturing in 2027) with TH to refinance debt and finance capital expenditure. Over the years, THP has disposed two of its plantation interests (TH Bakti Sdn Bhd in 2015 for RM16.3 million, and THP Gemas Sdn Bhd in 2016 for RM154.1 million) to cut hundreds of millions of ringgit of losses (NST, 2019). Also, according to the then Governor of Bank Negara, Zeti Akhtar Aziz (2016) "THP have broken numerous environmental regulations in Sarawak, Sabah and Kalimantan" (Sarawak Report, 2020). Clear-felling and present plantations by THP clearly transgress environmental standards on sustainability although THP claims it is a sustainable producer that holds a Malaysian Palm Oil Certification. To shelter THP from such challenges, in 2018 strategic rationalisation exercise was performed by transferring plantation assets to SPV (special-purpose vehicle). In 2019, THP announced to dispose its equity rights in two loss-making subsidiaries; Bumi Suria Ventures Sdn Bhd and Maju Warisanmas to Tamaco Plantation Sdn Bhd for a combined RM170 million. Both subsidiaries were acquired at a high cost of RM264.2 million in 2013 based on a total plantable area of 5,700 hectares (Ahmad, 2018b). However, an aerial survey in 2018 shown an actual plantable area is only 4,842 hectares, and valued by an independent valuer at RM183.9 million or RM11,425 per acre. According to THP, the sale of both subsidiaries is necessary to get funds in preventing THP defaulting its financial obligations.

4.2 TH and Social Investments through Sukuk

TH has undergone a series of critical and challenging financial crisis due to several factors which include: a severe equity capital market downturn leading to loss in investment (unrealised losses exceeded 50 per cent of original investment value; 40 per cent of TH's asset invested in domestic listed equities), difficult times in the property market, and adverse effects of significant errors in the investment decisions taken by the previous management (TH Annual Report 2018, p. 27). In 2016, BNM warned of "the worrying financial situation at TH which makes it difficult in the future for the TH to play an effective role in helping Muslim pilgrims to perform their Haj". According to the Central Bank governor, TH will face bankruptcy for its frequent investment and bailing out of non-profit-making crony ventures. Also, the Auditor's Report 2017 revealed that TH has failed to record the RM227.81million impairment on its investment in various subsidiaries. This was due to inconsistencies in TH's policy for asset impairment which was changed every year, and modified twice in 2017 (Ahmad, 2018b).

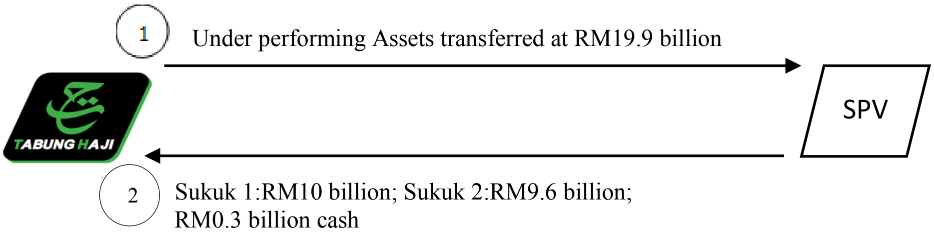
In 2018, the then Pakatan Harapan (PH) government released a damning report on TH highlighting illegal dividend distributions since 2014, assets shrinkage of more than RM4 billion and claims of accounting irregularities to mask a higher profit. Investigation by independent auditor PriceWaterhouseCoopers (PwC) unearthed that TH has total assets of RM70.3 billion against RM74.4 billion in liabilities at the end of 2017, a hole of RM4.1 billion. This indicates that every ringgit of TH's liabilities is backed by 94.4 sen in assets. The assets to liabilities ratio had widened from an estimated 98 sen to RM1 indicated by BNM at the end of 2015. The TH Act 1995 that governs TH prohibits dividend and bonus payments if the assets slide lower than its liabilities. PwC's financial position review for 2017, claimed that TH had paid *hibah* using depositors' savings and the fund had masked its profitability by structuring deals to show profits (Alifah and Prem, 2018).

To avoid such financial crisis that would disrupt TH's continued services to stakeholders and depositors, TH's new management team with concerted assistance of Prime Minister's Office, Prime Minister's Department, Ministry of Finance, Ministry of Economic Affairs, BNM and Securities Commission Malaysia to urgently embark on a comprehensive recovery plan to plug the hole. The management made urgent action which includes reconstructing its financial position statement to comply with the provisions of TH Act 1995. The aim of the restructuring and rehabilitation plan was to restore the balance sheet to enable *hibah* distribution while isolating problematic and low yield assets. After the cabinet approved of such plan, it was then presented to the parliament. The plan involves forming a government owned SPV, Urusharta Jamaah Sdn Bhd ("UJSB" or "Issuer") to take over, rehabilitate and maximise recovery of the TH's underperforming assets which include 106 listed domestic equities, one unlisted plantation equity and 29 properties and lands.

Figure 1 describes TH's mechanism of turnaround and restructuring plan. In addition to that, the SPV issued sukuk up to RM27.56 billion in nominal value under the Shariah principle of *Murabahah* (via *Tawarruq* arrangement) ("*Sukuk Murabahah*"), and on 30 May 2019 TH has subscribed the sukuk. Moreover, to support TH's rehabilitation and restructuring plan, the Government has committed to fund RM500 million in 2020 and RM1.73 billion annually from 2021 onward to the SPV for sukuk repayment purpose.

Sukuk was an obvious choice since Malaysia is the main global driver for the sukuk market which represents 48.8 per cent of the total global outstanding market, and 35.8 per cent of the total global Islamic funds asset under management as of September 2019 (Malaysian International Islamic Financial Centre (MIFC), 2019). According to the MIFC (2019), Malaysia ranked first with a total of 430 global funds, followed by Saudi Arabia with 203, Luxembourg with 202, and Pakistan with 180. Figure 1 shows the turnaround and restructuring plan for TH.

Figure 1: Mechanism of TH's Turnaround and Restructuring Plan



1 Underperformed assets are carved out for recovery amounting to RM19.9b. Criteria for potential assets include: (a) investment in equities with unrealized losses lesser than 20% and significant impairment; (b) no investment return; (c) properties and lands with yield more than 2.5%.

2 SPV issues two series of Sukuk totaling RM19.9b to TH as purchase consideration. For Sukuk 1: RM10.0 billion zero coupon Sukuk with the nominal value of RM13.2 billion over a seven year period with yield-to-maturity of 4.05 percent; Sukuk 2: RM9.6 billion zero coupon Sukuk with nominal value of RM14.3billion over a 10 year period with yield-to-maturity of 4.10 percent. If the SPV intend to sell those assets (to protect TH's interest when assets have potential upside), TH has the "First Right of Refusal" to take over from SPV any transferred assets.

After the restructuring and rehabilitation plan, any underperforming assets are substituted with Sukuk with 4.05 to 4.10 yield per annum. Sukuk subscription strengthened the composition of TH's asset which is in line with its new framework for strategic asset allocation that TH's total investment in fixed income asset class is capped at 55 per cent. Moreover, TH's total asset stands at RM76.5 billion that were in excess of its total liabilities of RM75.5 billion, and distributable profit of RM1.6 billion as at 31 December 2018 (TH Annual Report, 2018). Thus, TH was able to declare *hibah* distribution of 1.25 percent for 2018 amounting to RM923 million, which was in full compliance with the TH Act. However, TH still had to recognise the impairment of RM1.5 billion for financial year 2018 to ensure TH does not have to recognise any impairment in the future. Moving forward, TH will practice a more sustainable and prudent investment management. This is important in protecting the interest of 9.21 million depositors, ensuring smooth *hajj* operations, sustainable and strong financial position, as well as distributing of *hibah* that comply with the TH Act.

4.3 TH and Philanthropic Islamic Social Finance

Philanthropic ISF has long been a means for Islamic institution like TH to capitalise its available funds and resources in contributing towards economic sustainability of the Malaysian Muslims. It is through ISF that TH practices key Islamic ethical values of generosity, empathy, and concern for others by providing value-added services to its stakeholders and to the world cause.

TH as a responsible Islamic institution has done its share of zakat payment and distribution (TH Annual Report, 2018). On the perspective of TH as Malaysia's largest Islamic fund manager with more than RM41 billion funds, pays zakat contribution of their depositors, bonus and bonus percentage when investments has generate competitive returns for depositors. Table 3 shows TH's profit, zakat contribution, bonus and bonus percentage from 2010 to 2018. Since its inception in 1963, payment of additional *hajj hibah* only started in 2012. This special Golden Jubilee Bonus payout was in conjunction to its 50th Golden Jubilee Celebration in

2013, payment of 6.5% of annual bonus rate and a special bonus of 1.5% was made to its 8.2 million depositors. This payout comprised a total payment of almost RM2.5 billion, an increase of 47% against the RM1.7 billion payout in 2011. The total bonus payout was derived after business zakat payment of RM47.1 million in 2012, representing the highest bonus payout since the formation of TH 50 years ago.

Table 3: TH Profit, Zakat, Bonus & Bonus (%) (2010-2018)

Years	Net Profit (RM Million)	Zakat (RM Million)	Depositors' Hibah (RM Million)	Annual Hibah (%)	Hajj Hibah (%)	Hibah Rate (%)
2010	1,497	41.0	1,332	5.45	-	5.45
2011	1,689	44.0	1,678	6.0	-	6.0
2012	2,146	47.1	2,458	6.5	1.5	8.0
2013	2,634	53.0	2,632	6.0	2.0	8.0
2014	4,615	57.0	3,237	6.25	2.0	8.25
2015	3,216	59.0	3,220	5.0	3.0	8.0
2016	2,051	60.0	2,871	4.25	1.50	5.75
2017	3,385	68.0	3,324	4.50	1.75	6.25
2018	1,782	103.0	923	1.25	-	1.25

Source: Compiled from Annual Reports of TH 2010-2018

In addition, TH has been performing their role and contribution towards the ISF in the form of zakat distributions as below:

1. TH distributes its annual zakat payment to all zakat centres in all States in Malaysia.
2. Ehsan programme- this is an annual programme that focuses on offering financial assistance to the predetermined and underprivileged segment of the community specifically in the month of Ramadhan.
3. *Iqra* programme-this programme seeks to aid the potentially ambitious and performing *asnaf* students to ease their financial burden.
4. Mobility programme-selected mosques in Malaysia are given dual-function vehicles for usage either as passenger van or hearse.
5. Ikhtiar programme- another TH initiative in providing financial assistance in the form of business capital from their zakat fund to assist *asnaf* community for start-up business or improving existing business.

In addition to its zakat programme, TH has also participated in a cooperation partnership of waqf project with Islamic Religious Council Kuala Lumpur (MAIWP), Bank Islam Malaysia Berhad (BIMB) and TH. The 1.2 hectare of land in Jalan Perak, Kuala Lumpur was endowed in this waqf project by the late Ahmad Dawjee Dadabhoy, a rich businessman and successful tycoon who originated from Gujaret, India but later stayed in Malaysia until his demise in 1987 (Hartini, 2019). In this smart partnership project, MAIWP was the legal trustee, TH acts as the developer/ project manager offered a 100% financing based on the "Build-Operate-Transfer" financing structure. TH will lease the waqf land from MAIWP for 25 years with BIMB becoming the main tenant (Bello, 2020). In the long run, this waqf estate arrangement will benefit TH's stakeholders when the returns and profits from the waqf estate that TH received is given back to benefit the *asnaf*, depositors, Muslim community and Islamic economy in general.

TH through ISF has been financing sustainable development of its stakeholders for centuries. Key milestones achieved in 2018 by TH not only enhance the impact, governance, transparency of TH, but also reflect increasing enthusiasm amongst the stakeholders at large. ISF is part of the roadmap for sustainability of TH's business to move forward whereby huge consideration should be given on maintaining both its reputation and business feasibility in the emerging market.

5. Discussion: Post Covid-19 and ISF of TH

This study found that TH has been one of the most successful experiments in *hajj* management of the Muslim ummah worldwide, promoting sustainable development and aligning their impact on sustainability of the Muslim society since its inception in 1963. As an Islamic institution, TH has vitally important included ISF in its programmes since ISF is far more inclusive and widely-adopted worldwide. However, despite its success, the TH model has not yet been replicated in other Muslim countries. This section (Table 4) analyses the role of ISF as performed by TH as well as governance in the management of TH.

Table 4: TH, Governance and ISF

	2010	2011	2012	2013	2014	2015	2016	2017	2018
CSR	√	√	√	√	√	√	√	√	√
Technocrats appointees	√	√	√	√	√	√	√	√	√
Political appointees	√	√	√	√	√	√	√	√	-
Zakat	√	√	√	√	√	√	√	√	√
Hibah	5.45	6.0	6.5	6.0	6.25	5.0	4.25	4.50	1.25
Hajj Bonus	-	-	1.5	2.0	2.00	3.0	1.50	1.75	-
Sadaqah	√	√	√	√	√	√	√	√	√
Sukuk	-	-	√	-	-	-	-	-	√
Takaful	√	√	√	√	√	√	√	√	√
Kafalah	√	√	√	√	√	√	√	√	√
Waqf	-	√	-	-	-	-	-	-	-
Qard hasan	√	√	√	√	√	√	√	√	√

Source: TH Annual reports (2010-2018)

Some of key takeaways of this study include; one key trend is the significant impact of TH on the socio-economic development of Muslim society in Malaysia. TH does not just involve itself in *muamalat* activities, but also in *ibadah* activities where it is responsible in ensuring the welfare of the pilgrims. Besides supporting Malaysian equities in Bursa Malaysia, TH also creates a considerable business opportunity via its direct investments in the plantation sector, project management, and services. These group subsidiaries of TH open up many business prospects which in turn provide more business opportunities to others. More wealth per ringgit Malaysia is saved compared to the early days of keeping savings under the pillow or in the floor by the multiplier effect. Also, TH provides employment to more than 1000 Muslims all over the country with competitive remuneration just as other institutions. The employment opportunities and working experiences in TH subsequently create a new breed of Muslims who are conversant in both *muamalat* transactions and *hajj* management.

Another key trend is demand by stakeholders of enhanced governance, accountability and transparency of TH. Depositors' expectations in these areas are rising to provide check and balances to ensure that investments were made in the right places and evaluated professionally, and that every matter must be above the board. TH needs to be committed to important ethical issues such as CSR, good corporate governance and formalisation of ethics in financial economic theory and ISF.

Third, post C19 the use of digital technology will be on the increase. For depositors, digital technology provides greater access and makes it easier to identify, evaluate and fund causes of ISF while allowing greater reporting and communication. Perhaps most importantly, digital technology can help recipients of ISF and their communities to make resources more accessible and distribution more efficient.

Fourth, TH's explicit alignment with sustainability is a powerful trend that continues to grow post C19 pandemic. Financial institutions like TH can help social finance stakeholders identify the specific causes they wish to support and then design support programmes. TH can likewise support the implementation of ISF projects, and importantly the impact assessment and measurement of what need to be achieved.

Fifth, there is concern that TH is vulnerable to political pressure and abuse, given that the former PM Malaysia Najib Razak, who is on record for exploiting the fund to cover up 1MDB amid other suspicious investments since TH comes under the direct purview of the Prime Minister's Department (Mazwin, 2019). Also, from 2010 until 2017 politicians have been appointed to head TH, for instance Datuk Mohamed Aziz was a member Parliament of Sri Gading since 1999, an UMNO Chief, and the Permanent Deputy Chairman for UMNO Malaysia since 2008. Datuk Abdul Azeez Abdul Rahim is also a Member of UMNO Supreme

Council since 2008, a Parliament Member for Baling, and the Chairman of Yayasan Pembangunan Rakyat Baling, Kedah (Chester, 2017). This raises questions whether these political pressures are causing poor investment decisions by TH. Thus, TH should not be utilised for political but rather to be helmed by professionals and technocrats.

Sixth, the terms CSR and ISF are perceived as interchangeable which basically seems to offer similar meaning. However, both terms generally have subtle differences. Essentially, CSR by TH is driven by the need to maintain its reputation with regards to its contribution to the society and sometimes to fulfill requirements by politician and other stakeholders. CSR is a self-regulated business model that helps TH to be more accountable to a wide range of stakeholders to create societal impact, philanthropic strategy, and tactical efforts with the purpose of evaluating TH's contributions to the society for the previous business period in order to ensure correct image and reputation positioning in the market (Rexhepi et al., 2013). ISF on the other hand is driven by TH to create sustainable opportunities not in the current market but in the emerging market. Sustainability is the key agenda of ISF rather than maintaining image and reputation. ISF tools such as zakat and waqf can be leveraged to bridge financing gaps and creating social safety nets. ISF of TH does not look backward but rather focuses on potential business prospects in the emerging market. Even though both TH's CSR and ISF are philanthropic in nature, but both focus on different market, purposes and time period.

Seventh, TH's ISF ecosystem focuses on specific Shariah compliance instruments such as waqf, zakat, sadaqah and *qard Hassan* (benevolent loan) whereby all components and processes involved have to fulfill the Shariah principles without any allowable compromise (Jouti, 2019). There are evidences that financial returns and social responsibility can go hand in hand such as the Vaccine Sukuk and Malaysia's SRI Sukuk (Marwan and Engku Ali, 2016). Hence, IFIs like TH should offer more support towards ISF projects.

Finally, the question arises whether TH as the government-managed and "protected" fund has been run in the interests of pilgrims or for the rich and powerful in Malaysia. Interestingly, 5% of depositors control 75% of the funds in TH. In sustaining its high bonus rate, the reserves of TH were pushed into the red with liabilities outweighing the assets (The Edge, 2016). According to TH's annual report (2018), the bonus rate of 8.25% in 2014 was the highest given since 1998 (see Table 3). In 2012, TH paid RM2.46 billion in bonuses at a rate of 8% to its depositors, although net profit was only at RM2.15 billion. Similarly, in 2014 TH paid out RM3.24 billion *hibah* to depositors at a rate of 8.25% despite TH earning only RM2.98 billion.

6. Recommendations and Conclusion

TH has shown excellent contributions towards the society through the ISF tools and platform. It has impacted the Malaysian Muslim society such as fulfilling the national economic development policy particularly to help improve the status of the natives who are mainly Muslims and also as a symbol of economic strength of Malaysian Muslims. Their role should be replicated by other Islamic institutions or any Muslim owned businesses. Moving forward, TH as the financially viable and trusted Islamic institution should participate or initiate more waqf projects in the form of cash waqaf, land waqaf and *istibdal* waqaf (substitution of waqf property with another property or cash) land transactions. There have to be a reformed in the perception that waqf land should only be utilised for mosque, religious schools and mausoleum. There are more opportunities that can be reaped when waqf land are developed into vertical and community farming areas, converted into forest reserves or water catchment areas or through *istibdal*, various potential projects can be done to the like of the successful waqf project namely Taman Warisan Seetee Aisah project in Penang (Abdel Mohsin et al., 2016).

This study suggests that to capitalise its strengths in confronting future challenges in times of a C19 new landscape, TH should lead in ISF which is vital to achieve sustainable development. In view of the C19 pandemic, in their effort to offer financial assistance from zakat or cash waqf fund, TH should also focus on the new group categorized as urban poor. This group generally lives in the urban or sub-urban areas with no available land for farming to assist their families' basic needs. Finally, in its effort to contribute to the society, TH should also undertake a study on the impact analysis on all their ISF programmes. Such impact assessment can help TH to better engage with its stakeholders and global community while reinventing it as an effective post pandemic organisation which is done by embracing purposeful new technologies for business survival, enhanced governance practices, and forge internal partnerships. ISF is an appropriate means for TH to contribute domestically and expand its contributions to the world through forging international partnerships which demonstrates the relevance and contributions of TH to the global sustainability development.

Acknowledgement
The paper has been presented at the International Conference on Islamic Social Finance: Pandemic Crisis and Possible Solutions (Online) organized by the IIUM Institute of Islamic Banking and Finance on 29th – 30th September 2020. We thank the reviewers and the Journal Editor for the constructive comments for further improvement of the paper.

References

Abojeib, M., & Habib, F. (2019). Blockchain for Islamic social responsibility institutions. In *Fintech as a disruptive technology for financial institutions* (pp. 221–240). US: IGI Global.

Abdel Mohsin, M.I., Dafterdar, H., Cizakca, M., Alhabshi, S.O., Abdul Razak, S.H., Sadr, S.K., Anwar, T., & Obaidullah, M. (2016). *Financing the development of old waqf properties. Classical principles and innovative practices around the world*. New York: Palgrave Macmillan.

Ahmad N.I. (2018a). Tabung Haji to be put under BNM supervision from Jan 1. The Edge Markets. Retrieved on 7/9/2020 at https://www.theedgemarkets.com/article/tabung-haji-be-put-under-bnm-supervision

Ahmad N.I. (2018b). Tabung Haji failed to report RM227.81m impairment in 2017 — AG report. Retrieved on 7/9/2020 at https://www.theedgemarkets.com/article/tabung-haji-failed-report-rm22781m-impairment-2017-%E2%80%94-ag-report

Alamad, S. (2019). Introduction: the basics of Islamic economics and finance. In *Financial and Accounting Principles in Islamic Finance* (pp. 1–20). Springer.

Alifah Z., & Prem K. (2018). Tabung Haji scandal and illegal dividends. Retrieved on 7/9/2020 at https://themalaysianreserve.com/2018/12/11/tabung-haji-scandal-and-illegal-dividends/

Azam, M., Akhtar, J., Ali, S. A., & Mohy-Ud-Din, K. (2019). The moderating role of Shariah compliance on the relationship between firm profitability and CSR activities. *International Journal of Ethics and Systems*, *35*(4), 709-724.

Azman, S. M. M. S., & Engku Ali, E. R. A. (2019). Islamic social finance and the imperative for social impact measurement. *Al-Shajarah (Special Issue in Islamic Banking and Finance)*, 43–68.

Baig, U. (2016). Hajj management in Pakistan in the light of experience of Tabung Haji of Malaysia. *International Journal of Islamic Economics and Finance Studies*, *2*(2), 13–39.

Bello, H., Ayob, M.F., & Sarkawi, A.A. (2020). Assessment of waqf models for provision of affordable housing in Malaysia: a case study of Majlis Agama Islam Wilayah (MAIWP). *Journal of Architecture, Planning and Construction Management*, *10*(1), 55-67.

Cattelan, V. (2018). *Islamic social finance: entrepreneurship, cooperation and the sharing economy*. Routledge.

Chester, T. (2017). Glomac appoints Tabung Haji CEO as alternate director. Retrieved on 7/9/2020 at https://www.edgeprop.my/content/1147436/glomac-appoints-tabung-haji-ceo-alternate-director

Dettman, S., & Gomez, E. T. (2020). Political financing reform: politics, policies and patronage in Malaysia. *Journal of Contemporary Asia*, *50*(1), 36–55.

Geva, A. (2008). Three models of corporate social responsibility: Interrelationships between theory, research, and practice. *Business and Society Review*, *113*(1), 1–41.

Habibullah, M. S., Baharom, A. H., Din, B. H., & Furuoka, F. (2017). Mitigating shadow economy through dual banking sector development in Malaysia. In *Money in Islamic Banking System in Islamic Economies-Stability, Markets and Endowments,* 41–62. Palgrave.

Haneef, M. A., & Tahir, S. (2018). Rethinking Islamic economics and finance: taking stock and moving forward. *Intellectual Discourse*, *26*, 281–290.

Hartini, M. H. S. (2019). Sustainable development of waqf property: conceptual analysis. *Jurnal Intelek*, *14*(1), 26–35.

Haseeb, M. (2018). Emerging issues in islamic banking & finance: challenges and solutions. *Academy of Accounting and Financial Studies Journal*, *22*, 1–5.

Husseini, S. A., Fam, S.-F., Ahmat, N. N., Azmi, F. R., Prastyo, D. D., & Yanto, H. (2019). Islamic banking revolution in Malaysia: a review. *Humanities & Social Sciences Reviews*, *7*(4), 267–275.

Ibrahim, T. A. F. T., Hashim, H. A., & Ariff, A. M. (2020). Ethical values and bank performance: evidence from financial institutions in Malaysia. *Journal of Islamic Accounting and Business Research, 11*(1), 233-256.

Ishak, M. S. (2011). Tabung Haji as an Islamic financial institution for sustainable economic development. *International Proceedings of Economics Development & Research 17*, 236-240.

Ismail, S. B. (2020). The conduct of the hajj and its social impact on the muslim community in Malaysia 1975-2005. *Journal of Islamic*, *Social, Economics and Development (JISED)*, *5*(28), 25–38.

Jouti, A. T. (2019). An integrated approach for building sustainable Islamic social finance ecosystems. *ISRA International Journal of Islamic Finance*, *11(2)*, 246-266.

Kamaruddin, N., & Rogers, R. A. (2020). Malaysia's democratic and political transformation. *Asian Affairs: An American Review*, *47*(2), 126–148.

Madani, I. (2016). World humanitarian summit: Islamic social finance. *UN Chronicle*, *53*(1), 1–3.

Mansor, N., Jamil, A., & Bahari, A. (2018). Waqf reporting: a modified integrated reporting for sustainable islamic social finance. *International Journal of Academic Research in Business and Social Sciences, 8(12)*, 155-166.

Mansoro, M. N. (2020). Islamic banking and financial institutions in Malaysia: current developments. *Journal of International Studies*, *5*, 109–123.

Marwan, S., & Engku Ali, E. R. A. (2016).The potential of innovative financial tools: Social Impact Bond (SIB) and Sustainable and Responsible Investment (SRI) sukuk, towards the sustainable growth of the islamic finance industry. *European Journal of Islamic Finance*, *4*, 1-8.

Mazwin, N.A. (2019). PMO: Tabung Haji remains under purview of PM's Dept. Retrieved on 7/9/2020 at https://www.thestar.com.my/news/nation/2019/02/25/pmo-tabung-haji-remains-under-purview-of-pms-dept

MIFC (2019). Malaysia's local currency Sukuk market outperforms expectations. Retrieved from, http://www.mifc.com/index.php?ch=ch_kc_definitions&pg=pg_kcdf_products&ac=332

Muheramtohadi, S. (2019). The use of Hajj fund for investment purpose: a Maqashid Sharia approach. *Journal of Islamic Economics, Management, and Business*, *1*(1), 119–136.

New Straits Times (NST) (2019). TH Plantations sells two loss-making units for RM170mil. Retrieved on 7/9/2020 at https://www.nst.com.my/business/2019/12/545497/th-plantations-sells-two-loss-making-units-rm170mil

Rexhepi, G., Kurtishi, S., & Bexheti, G. (2013). Corporate social responsibility (CSR) and innovation the drivers of business growth. *Procedia-Social and Behavioral Sciences*, *75*(3), 532–541.

Sarawak Report (2020). Religion vs Greed - New Tabung Haji scandal looms over the PN government? Exclusive. Retrieved on 7/9/2020 at https://www.sarawakreport.org /2020/03/religion-vs-greed-new-tabung-haji-scandal-looms-over-the-pn-government-exclusive-2/

Tahir, M., & Abidin, Z. (2017). Birth and growth of Bank Islam Malaysia. In Mohamad Ariff Abdul Kareem (Ed.), *Islamic Finance in Malaysia: Growth and Development*, 55-86. Kuala Lumpur: Pearson.

Tabung Haji Annual Report (2013). Retrieved on 7/9/20 at https://cms-th.s3.amazonaws.com/Lembaga+Tabung+Haji+Annual+Report+2013.pdf

Tabung Haji Annual Report (2018). Retrieved on 7/9/20 at https://www.tabunghaji. gov.my/en/corporate/corporate-information/five-5year-data-statistics

The Edge (2016). Bank Negara issues warning to Tabung Haji. Retrieved, from https://www.theedgemarkets.com/article/bank-negara-issues-warning-tabung-haji

Yusuf, M.-B. (2011). Effects of spiritual capital on Muslim economy: The case of Malaysia. *Research on Humanities and Social Sciences*, *1*(2), 23–40.

Yusuf, M.-B. O., Shirazi, N. S., & Abdullah, M. A. (2016). Regulatory framework for member-owned Islamic microfinance institutions (MIMIS) in Sub-Saharan Africa (SSA). *Journal of Islamic Economics, Banking and Finance*, *113*(3517), 1–17.

Zandi, G., Kamil, N. M., Sulaiman, M., Ishak, I. C., & Sahudin, S. (2017). Islamic spirituality and continuance organizational commitment: the case of Malaysian organizations. *Journal of Islamic Management Studies*, *1*(1), 54–71.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 70-78
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Application of Artificial Intelligence (AI) in Islamic Investments

Haneffa Muchlis Gazali*, Junisa Jumadi,
Noor Rasyidah Ramlan, Nurmaisarah Abd Rahmat,
Siti Nor Hazilawati Mohd Uzair, Amirah Norliyana Mohid

Universiti Malaysia Sabah Labuan International Campus

Corresponding author: haneffa@ums.edu.my

Abstract

This study examines the application of Artificial Intelligence (AI) in Islamic Investments. AI technology is very popular in both the conventional and Islamic banking systems as reflected in the contributions of AI in Islamic investment. The technology helps investors to analyse their stocks in terms of price levels, the current stability of each stock and the future price forecasts based on current price and stock data. The study is a conceptual discussion on the application of AI in Islamic investment, which focuses on the discussion of Text Mining, Algorithmic Trading, Stock Pick and Robo in Investment, which include Robo Advisor, Robo Islamic Advisor (RIA) and Robo Financial Advisor (RFA) operating in Islamic investment system. Thus, the discussion dwells on the cognitive application along with investment and compliance sectors of the financial services industry. The conclusion of the study highlights the implications, limitations and future research of the subject matter.

Keywords: *Artificial intelligence, Malaysia, Islamic investment system, robots in investment*

1. Introduction

The Islamic financial industry acceptance towards the use of Artificial Intelligence (AI) technologies in investment is particularly important especially as to how the use of AI will affect the Islamic financial growth in Malaysia (Tuomi, 2018). Islamic finance industry is financial activities in accordance with Shariah (Islamic law) in which all operations carried out by this industry should not be involved with *riba, gharar and maysir* (Hussain, 2015). Islamic Finance involves Islamic Financial Institutions (IFIs) where the objectives and operations of the institutions are based on the principles of the Holy Quran (Tabash and Dhankar, 2018). This means that an IFI is not just a bank, but it also covers other types of financial intermediaries that follow Shariah principles in its business conducts. The other point of departure is that the Shariah ostensibly requires the adjustment of all aspects of Muslims' lives and the formation of a complete moral system (Tabash and Dhankar, 2018). In relation to the AI technology, Mat Rahim et al. (2018) explained that digital banking 4.0, FinTech banking and AI have recorded potential applications since 2017 (refer Figure 1).The presented fact testifies to the relevance of the current study in providing adequate information on how the Shariah-based Islamic financial industry aligned with the technological developments such as AI, particularly in terms of Islamic investment.

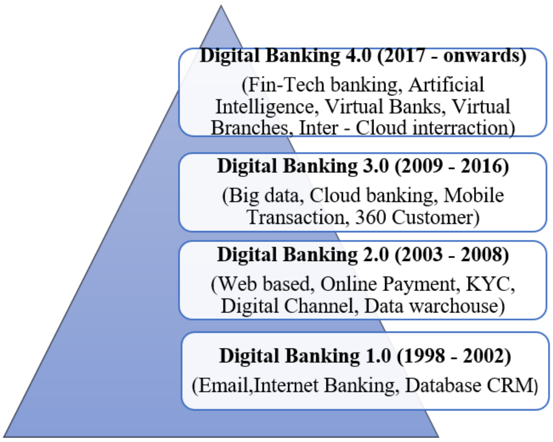
Since the establishment of the Islamic financial system in Malaysia in 1963, it has seen tremendous growth in the development, demand and acceptance of the system among the Malaysian society. Subsequent to the establishment of the Malaysian Pilgrims Fund Board (Tabung Haji), Bank Islam Malaysia Berhad (BIMB) was the first Islamic Bank to operate on 1 July 1983 and has become the core component of the Islamic financial system in the country. The objective of Islamic banking then was limited to the development

Article history:
Received 5 November 2020
Revised 26 November 2020
Accepted 4 December 2020

of modern and viable alternatives to meet the financial needs of the Muslims. Malaysian banking is now modelled as one of the most advanced Islamic banking system in the world (Hussain, 2015).

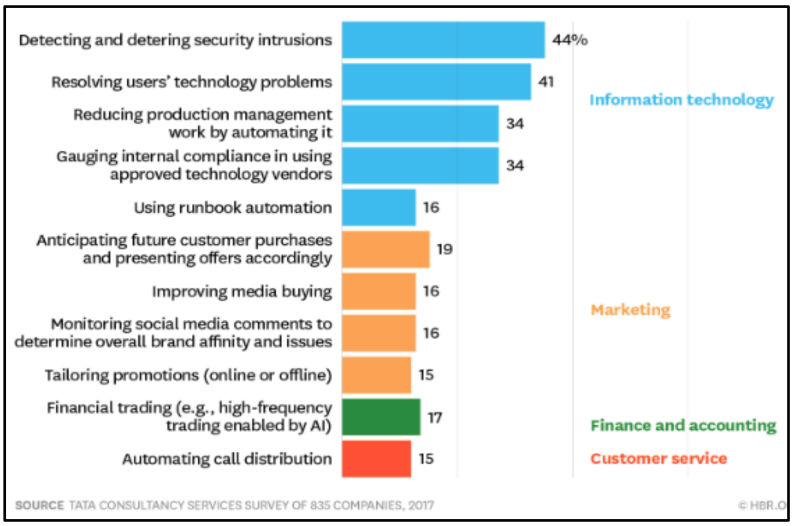
According to Mijwel (2015), the concept of AI has been around since the ancient times, but the advent of digital computers in the 20th century has brought the AI concept to a higher level. AI was understood as a field of computer science in the mid of 1950s. The term AI has been applied to computer programs and system which are capable of more complex tasks than ordinary computers. Although the AI system is not yet in at the level of human intellect and thinking, it has been widely used in specific areas such as information processing, computer games, national security and financial services. The development of AI has led to the use of smart contracts, Robo Advisor Islamic Banking, Robo Islamic Advisors (RIA), Robo Financial Advisor (RFA), Robo Mentor and Smart *Muftis,* especially in the Islamic financial services (Fazmi, 2019). AI contains all information about the sender, receiver and analysis of the financial performance. As a result of its rapid development, the systems can contribute to both conventional and Islamic financial systems. The use of AI technology among firms in the world is reported by Ramaswamy (2017) (Refer Figure 2).

Figure 1: Digital Banking Evolution



Source: AI, Smart Contracts and Islamic Finance (Mat Rahim et al., 2018)

Figure 2: The Use of AI among Investment Companies Around the World.
TATA Consultancy Services Survey on 835 Companies in 2017



Source: (Ramaswamy, 2017)

Investment is an asset or item that is purchased with the hope that it can generate income in the future. Based on Jiao (2018) investment is an activity of purchasing of valuable goods to generate wealth in the future. In finance, an investment is a monetary asset which is purchased with the idea that the asset will be sold at a higher price to earn profit. In Shariah, the elements of *riba, gharar and maysir* are prohibited because they are regarded as long-term abuse of behaviour between human (Mijwel, 2015). Hence, the prohibited elements must be controlled in order to bring peace in this world and the hereafter (Mijwel, 2015).

Nowadays, as customers become more sophisticated and knowledgeable, they prefer to make financial transactions with less human interaction (Mat Rahim et al., 2018). Hitherto, the scope of technology is expanding and has the potential to improve the efficiency of the overall financial system. One of the popular tools to improve efficiency is the smart contract: a computer program that can record and list all receivers and senders (Mat Rahim et al., 2018). This computer program also has applications in other areas such as in the banking system, insurance (takaful) and management. Formulated as any other technology and innovation-driven, AI might be adopted in some Islamic finance products. Mijwel (2015) found that AI can create machine learning tools and deep neutral networks, which can bring a whole new experience to the financial industry.

Previous research revealed that AI will have a huge impact on the future of the Islamic finance industry (Mat Rahim et al., 2018). Dahlan (2018) in his study discovered that the inclusion of AI into the way of life of Muslims is affecting their daily life despite being not significant. For an example, Wahed Invests is an online Halal investment platform that has facilitated and used more automation in Islamic investment. They have also provided cost-effective access to Shariah-compliant equity investments (DinarStandard, 2018). However, Hussain (2015) stated that the implementation of AI to evaluate products/services with Islamic features will be challenged.

Several studies have focused on the impact of AI in financial services and its influence on economic growth. However, there has been very little effort to explore the impact of Islamic finance principles on economic growth using AI. To fill this literature gap, this study investigates the potential effects of AI in Islamic investment and instruments on economic growth. We believe that the results of this study will help decision-makers and investors from local and global markets to understand the advantages of AI in Islamic investments, and their role in enhancing economic growth of a nation.

This study centrally examines the applications of AI in Islamic investments. It is hoped that this study will provide a better understanding about AI technology in Islamic finance investment. At this age of rapid advancement in technology, AI will certainly be useful to support human intelligence as it could process and store big data. This study intends to provide an understanding of the development of AI into the financial industry, to assess the performance of AI implementation in the investment industry, to highlight the potential of AI in supporting the financial industry and to promote the application of AI technology in the Islamic financial system in Malaysia.

This study begins with the discussion of the history of AI, the research problems, questions and objectives. The second part explains the emergence of literature in the context of AI in Islamic investment. Next is the discussion on how the AI works in helping the investment activities in the Islamic financial system. The final part concludes the study with a discussion on implications, limitations and future research.

2. Literature Review

In this section, we review the related literature of the study. The literature review will enlighten the discussions on Text Mining, Algorithmic Trading, Stock Picks and Robots in Investments.

2.1 Text Mining

In the Business-to-Consumer (B2C) market, more businesses are interested in using big data analysis. Firms are creating a network-driven partnership, involving vast amounts of information flow across and within firms (Kang et al., 2018). Some of the businesses tried several combinations of unigrams, bi-grams and trigrams as features in the use of support vector machines. Understanding the impact of text mining on knowledge discovery is the focus in assisting practitioners to develop big data analytic projects and researches. Mostly, people will look at fast access to the relevant information that helps them address what they need. There is a need to learn a new subject or solving a specific problem. Text mining has been used in many sectors, such as education, government, health care and manufacturing. The text mining process involves several technologies such as pattern matching, topic tracking, summarisation, clustering, categorisation, etc. Pattern matching for example, increases the knowledge discovery process by using text mining which has attracted interest of a variety of fields such as business and finance. This requires much effort to gather non-trivial information and provide more significant opportunities in implementing a knowledge discovery process (KDP). It allows discerning trivial and non-trivial text data and grasping knowledge present in a large amount of unstructured data. After converting it to a specified structured format, text mining applies the techniques of data mining to the corpus of textual data (Kumar and Ravi, 2016). Text mining is still devising more efficient techniques that are essential for handling and predicting significant data despite the availability of several text mining applications currently. The efficient techniques of text mining are targeted for better prediction by combining numerical data and textual data. Due to its high potential, text mining is vital in every field, including finance.

2.2 Algorithmic Trading

Bendtsen and Peña (2016) stated that algorithmic trading is a process that actively decides when to trade an asset and when not to trade it, to match risk and reward on invested capital on short-term strategy and to compare with holding the asset on a long-term strategy. One of the main reasons why algorithmic trading is becoming so popular is due to its advantages compared to a manual trade. Algorithmic trading offers some advantages related to accuracy, speed and cost reduction (Lakshmi, 2017). Reid (2019) quantified that algorithm trading provides asset liquidity through quick buy and selling orders. Its impact on liquidity is further revealed in the currency market after the Swiss Franc stopped holding the Euro in 2015 (Reid, 2019). According to Zavadskaya (2017), several companies have successfully used algorithmic trading. Sentient Investments, an investment company, uses AI in the form of machine learning (algorithm trading) to develop reasonable quantitative investment and trading strategies. Additionally, algorithm trading is the latest form of AI that has deep learning and image recognition to scan through all the available information and try to figure out a relevant investment strategy for investment decisions. Further, Schmelzer (2019) analysed that some banks delve deep into the AI world by using smart systems to assist them in making investment decisions and to support their investment banking research. Firms like UBS and ING based in the Netherlands have AI system tracking the market for unexplored investment opportunities and later inform their algorithmic trading system. While humans are still at a disadvantage with all investment decisions, AI system on the other hand reveals additional opportunities through better investment modelling and discovery. Following these advantages, algorithmic trading is expected to reduce costs and minimise human error in making investment decisions.

2.3 Stock Picks

According to Agrawal et al. (2019), AI processes large amounts of information much faster and makes predictions more precise than is humanly possible. In relation to this, Wang (2014) stated that AI has many benefits to be used for investing as it can analyse thousands of data in a short period that even human beings are not capable of performing. This is further supported by Brandt (2017) that AI is also being used to achieve faster resolutions, assist customer inquiries, achieve better investment results and risk assessment. AI, hence, will play a significant role in financial services development in which automated financial planners help investors in making financial decisions. The system (AI) includes monitoring activities, stocks and bonds price trends according to the financial goals and personal portfolio of the investors, called “Robo Advisors” (Brandt, 2017). AI is capable of transferring or adapting knowledge gained from one setting to a different setting. Based on Gil et al. (2019), today's most effective financial machine learning requires a large amount of training data, which involves significant investment and expenses to develop. Ahmed (2018) however argued that humans are still capable of improving investment performance and can think better in selecting stocks for investment without having to be bound to the created system. Furthermore, Ahmed also explains that humans will experience extreme job losses because of the implementation of AI. Zavadskaya (2017) stated that by gaining more data, it can be a guide for investors to buy and sell stocks at a target price in future. This is because AI is capable of analysing large amounts of data and can make near-accurate predictions of stock prices in the future. In this regard, Ali (2019) explained that AI is one of the most promising models used by researchers to predict stock movement because Artificial Neural Networks (ANN) can approximate any nonlinear function to an arbitrary degree of accuracy with a fair number of hidden units.

2.4 Robots in Investment

AI has assisted many processes of the Islamic financial industry including investments, retirement planning and wealth management. In today's' world, many robotic models have been created that possess the AI features that can help to ease the work of humans in many aspects of life. This includes the AI robotic model of Robotic Radio Frequency Ablation (RFA) Surgery that was created to perform minimally invasive ablation surgery based on commonly used clinical radio frequency needles. Therefore, in order to perform an extensive and multi-purposed liver tumour case with precision, high consistency and efficiency, the RFA is very appropriate (Tan et al., 2017). According to Buchanan (2019), the term "Robo Advisor" was essentially non-existent a decade ago, but it is now relatively a common term in the financial landscape. However, despite the term "Robo", the advisory process does not involve robots at all. Instead, Robo Advisors are algorithms built to calibrate a financial portfolio based on the investors' investment goals and risk tolerance. This advancement in financial advisory will therefore help policymakers take the right steps in formulating investment policies. Buchanan (2019) reported that Robo Advisors (chatbots) are powered by natural language processing (NLP) and machine learning (ML) algorithms and have become powerful tools to provide a personalised, conversational and natural experience to users in different domains.

Robo Advisors (chatbots) have gained significant appeal with millennial consumers who do not need a physical advisor and may feel more comfortable in dealing with robots while investing. Further, Robo Advisors offer are cost-effective since no fees are to be paid to human advisors and AI has provided all the relevant information pertaining to the investment decisions such as the gross domestic product, inflation, deficit and relevant data on companies' performance before making any investments (Jiao, 2018). According to Beketov et al. (2018), the wealth management industry is currently facing a new generation of investors which they are educated, technology literate and savvy, prefer to have control over their investment, actively seeking information virtually and less dependent on the financial advisors.

2.4.1 Robo Advisor

According to Fazmi (2019), Robo Advisors are becoming smarter and faster day by day and play an important role in IFIs. This includes Robo Advisors in Islamic Banking, Robo Islamic Advisors, Robo Financial Advisors, Smart *Muftis* and Robo Mentors. By implementing this technology, it can help the industry to gain an area that has massive visibility, cost efficiency and increased productivity (Fazmi, 2019). Besides, Robo Advisor can help the player to develop their business and ensure long term success. According to Margin (2019), Robo Advisor helps the process and direction of businesses. Also, it has been crucial sources for market players, helping IFIs' customers in the various application area and as a market solution. According to Carey (2019), USD 2.2 trillion size of the Robo Advisor market are predicted by 2020 although the assets under management as at September 2019 are very much lower. With the implementation of this technology, wealth managers can focus on affluent investors who are underserved with the combination of human and digital engagement. It is also stated that the Robo Advisor gets its assets under management base on the initial tract that was projected. Another suggestion was to re-framed the machine-human interface to human vulnerability so that the machine is more sensitive to human vulnerability. Thus, Robo Advisor can be a better asset allocator than human advisors (Beltramini, 2018). To conclude, Robo Advisor plays a significant role in providing better investment opportunities and it gives a positive impact on the industry.

2.4.2 Robo Islamic Advisor (RIA)

Robo Islamic Advisor (RIA) is the world's first automated Islamic investment platform to customers (Friedberg, 2019). RIA aims to provide access to *halal* portfolio management for 2 billion Muslims around the world (Friedberg, 2019). Besides, the introduction of RIA is considered to be the world's first automated ethical investment platform. Wahed Invest (the investment company) offers a lower minimum investment of USD 7,500 as a starter. The investment company claims to be the first global Robo Advisor and their services are accessible for the lower socio-economic demography (Fazmi, 2019). In the beginning, Wahed Invest is only available in the United States; it then expanded its business to over 100 countries worldwide by 2017. Two months after the launching of the world's first Islamic Robo Advisor, another company known as the Kuala Lumpur-based Farringdon Group launched the Asia's first Shariah-compliant Robo Advisor (Global Islamic Finance Report, 2017). The online tool, called Algebra, will provide automated portfolio management advice and will be opened to investors across all geographies with a minimum investment of USD 200 per month. In this regard, clients can choose funds from its Islamic Master Select Portfolio (Rahman, 2019). This shows that RIA is important in Islamic investment where it will help investors to perform investment on an Islamic platform.

2.4.3 Robo Financial Advisor (RFA)

Islamic banks can feed data into RFA on all available Shariah compliant investment options. This will also encourage the industry to expand its wealth management schemes because with RFAs the visibilities for those investment options will be gaining momentum (Fazmi, 2019). In relation to this, when a Shariah-compliant investor wants to know his or her return, the investor can enter his or her preferences. The robot (RFA) will analyse the various patterns, trends, options and provides the best possible return on investment (Fazmi, 2019). This will pave the way for a universal Islamic wealth management options. Therefore, the services are accessible at any time so investors can analyse and compare the possible results. Following this innovation, the notion that Islamic banking is only for Muslims can be eradicated.

3. Islamic Investment System

In this digital age, the inclusion of AI in investment can be seen more widely. In this regard, it is important to ensure that the investments not only generate good returns, but preserve good ethics and values as well (Wahed Invest, 2017). Times (2019) stated that there are still many broad opportunities to offer ethical inputs as well as ethical principles following Islamic teachings where Islamic ethics is based on Shariah (Islamic law), *fiqh* (jurisprudence), *urf'* (customers practices), and *qanun* (ordinance). AI can help to make wise decisions on stock investing, as well as Shariah-compliant stocks (MyFinB, 2019).

Mookerjee (2017) stated that the neutral network technology (AI) which is developed by a Californian start-up (Maxsys), will be used by Malaysian-based company in order to construct investment portfolio comprising of 20-50 stocks from the Shariah-compliant universe of the S&P 500 Index. This index is based on 125 component stocks that fit with Islamic principles. The machine-learning algorithm (MLA) will process millions of data points from new flow of data obtained, stock volumes and any other market data to come out with a stock recommendation. There will be two portfolio managers who will subsequently manage the final call to the end client upon recommendation from the MLA (Mookerjee, 2017). Beltramini (2018) further stated that machines are used to decrease human imperfection; the machine nevertheless does not decrease human vulnerability because technology advancement does not affect human nature. Despite this, Mookerjee (2017) commented that consumers are still in doubt on the effectiveness of AI and machine learning because it is still new. Mookerjee further stated that human beings are the ones who will act at the end of the process, not the machines.

3. Discussion and Conclusion

The Islamic financial industry's acceptance towards the use of Artificial Intelligence (AI) technologies in investment is particularly important as the use of AI affects the Islamic financial growth in Malaysia. This study meets its objective in reviewing the impact of Text Mining, Algorithmic Trading, Stock Pick, and Robo in Islamic investment system based on the application of AI in Islamic investment. First is on Text Mining in which this is one of the technologies to extract information from the vast amount of big data. After converting the information into data format, Text Mining applies the data mining technique to the corpus of textual data (Kumar and Ravi, 2016).With big data, data mining method will help investors analyse market data, price levels and perform forecasting activities. Bach et al. (2019) confirmed that Text Mining had been used in many sectors, such as education, government, health care, and manufacturing. Pattern matching, topic tracking, summarisation, clustering, categorisation, and information are the technologies in the Text Mining process. Pattern matching, for example, increases the knowledge discovery process using Text Mining which has attracted interest from a variety of fields such as finance, business and AI. In this regard, this study led to the discussion on the factors that affect the acceptance rate of AI application in Islamic investment.

Algorithmic Trading (AT) as part of AI is the instrument used in Islamic investment to reduce possible errors that could occur during the trading process by investors. This is due to AI's capabilities to place an investment for investors in a more accurate and effective process in comparison to trades placed by humans which sometimes are exposed to mistakes due to wrong decision-making process. The AT helps several investment companies in making investment decisions by scanning all the market or stock information. Most importantly, AT can reduce cost and minimise human errors throughout the investment decision-making process.

This study also discovered that Stock Pick has proven to help investors to predict future market price such as through market analysis, logistics planning along with the management of the stock more accurately and systematically, thus improving the market timing. Stock Pick also helps investors to make an investment decision by referring to all the analysed data based on the current market price and stock movement and subsequently for investors' future investment.

Considering AI to operate in the Islamic investment system, AI brings a positive impact to the consumers in making smart decisions in Shariah compliant stocks investment as AI can provide a high-quality service in the investment system. In this case, AI can provide lots of advantages to its uses since it is Shariah compliant and does not affect the human nature.

Since today is the era of robots which are becoming smarter and faster day by day, Robo in investment has played a significant role in Islamic investment. This is due to the easy use of robots' financial advisors, coupled with the lower fee model for professional Islamic investment management. Apart from that, it is also believed that Robo investment can help investors to mitigate risks in investment. Further, robots' financial advisors can help to make a better decision in Shariah compliant investment since users can restrict the scope of investments to exclude alcohol, gambling, speculative and any activities which are not according to Shariah.

This study, therefore, has opened many future research opportunities in the area of AI in Islamic investment and discovered many new factors that contribute to the development of AI in investment system. Besides, the present study appears to be the first attempt to discuss the application of AI in Islamic investment thoroughly and contributes to the existing knowledge in the context of Islamic investment. This study also helps to increase the understanding of the uses of the AI application in Islamic investment among Malaysian investors.

The findings of this study, lead to several policy implications. For the practitioners, this study will be a benchmark to provide investment products and services which employ the application of AI. While to the policymakers, this study will be considered as a stepping stone for preparing the regulatory framework for the investment industry related to AI. Therefore, it is crucial that this area of study be continued and further developed to facilitate financial flows in the Malaysian economy in particular.

This work has examined a range of issues pertinent to AI and its implementation in the Islamic financial industry. Most importantly, this study adds to the existing literature in Islamic finance and financial technology. This work suffers from several limitations - notably related to detailed application and user acceptance on the implementation of AI in Islamic investment. In future work, it may be useful to study on the other aspects of Shariah compliant investment not covered in this study where the use of AI is possible. Besides, the current study suggests that future research may explore and provide empirical evidence on the understanding of investors towards the application of AI in Islamic investment.

Acknowledgement
The paper was submitted to the International Conference on Islamic Social Finance: Pandemic Crisis and Possible Solutions (Online) organized by the IIUM Institute of Islamic Banking and Finance on 29th – 30th September 2020. We thank the Journal Editor for the constructive comments for further improvement of the paper.

References

Ahmed, H. E. (2018). AI Advantages and disadvantages. *International Journal of Scientific Engineering and Applied Science (IJSEAS), 4*(4)*,* 22–25.

Agrawal, A., Gans, J., & Goldfarb, A. (2019). *The economics of artificial intelligence*. Chicago: The University of Chicago Press.

Beketov, M., Lehmann, K., & Wittke, M. (2018). Robo advisors: quantitative methods inside the robots. *Journal of Asset Management*, *19*(6), 363–370.

Beltramini, E. (2018). Human vulnerability and robo-advisory: an application of Coeckelbergh's vulnerability to the machine-human interface. *Baltic Journal of Management*, *13*(2), 250–263.

Bendtsen, M., & Peña, J. M. (2016). Gated Bayesian networks for algorithmic trading. *International Journal of Approximate Reasoning*, *69*, 58–80.

Brandt, J. (2017). Artificial intelligence applications in financial markets forecasting. a systematic mapping. Retrieved November 12, 2020, from https://www.diva-

portal.org/smash/record.jsf?pid=diva2%3A1168746&dswid=5846
Buchanan, B. G. (2019). *Artificial intelligence in finance*. Retrieved November 12, 2020, from http://doi.org/10.5281/zenodo.2612537
Carey, B. Y. T. W. (2019). Robo-advisors 2019: still waiting for the revolution. Retrieved October 15, 2019, from https://www.investopedia.com/robo-advisors-2019-where-have-all-the-assets-gone-4767826
Dahlan, H. A. (2018). Future interaction between man and robots from Islamic perspective. *International Journal of Islamic Thought*, *13*(1), 44–51.
DinarStandard. (2018). Islamic fintech report 2018: current landscape & path forward. 1–38. Retrieved November 12, 2020, from https://www.dinarstandard.com/wp-content/uploads/2018/12/Islamic-Fintech-Report-2018.pdf
Fazmi, F. (2019). Role of robo-advisors in Islamic financial institutions. Retrieved November 12, 2020, from https://journal.wahedinvest.com/role-of-robo-advisors-in-islamic-financial-institutions/
Friedberg, B. A. (2019). Wahed Invest: a look at the new islamic robo-advisor. Retrieved November 12, 2020, from https://www.investopedia.com/articles/personal-finance/112516/wahed-invest-peek-new-islamic-roboadvisor.asp#:~:text=Both%20access%20and%20investments%20are,risk%E2%80%94than%20their%20traditional%20competitors.
Gil, Y., Selman, B., Desjardins, M., Forbus, K., Mckeown, K., Weld, D., & Drobnis, A. S. (2019). A 20-Year Community Roadmap for Artificial Intelligence Research in the US Roadmap Co-chairs: Workshop Chairs: Steering Committee. Retrieved October 15, 2019, from https://bit.ly/2ZNVBVb
Global Islamic Finance Report. (2017). *Islamic Finance in the Digital Age*, 282–290.
Hussain, M. S. (2015). An overview of Islamic finance. *IMF Working Paper.*
Jiao, Y. (2018). Applications of artificial intelligence in e-commerce. Retrieved October 15, 2019, from https://tel.archives-ouvertes.fr/tel-01892576/
Kang, M., Ahn, J., & Lee, K. (2018). Opinion mining using ensemble text hidden Markov models for text classification. *Expert Systems with Applications*, *94*, 218–227.
Kumar, B. S., & Ravi, V. (2016). A survey of the applications of text mining in financial domain. *Knowledge-Based Systems*, *114,* 128-147.
Lakshmi, R. (2017). Survey of algorithmic trading strategies in equities and derivatives. *International Journal of Mechanical Engineering and Technology (IJMET)*, *8*(12), 817–825.
Margin, G. (2019). Robo-advisor market trends 2019 growth by top companies. Retrieved October 15, 2019, from https://wheelchronicle.com/2019/10/14/robo-advisor-market-trends-2019-growth-by-top-companies-betterment-futureadvisor-personal-capital/
Mat Rahim, S. R., Mohamad, Z. Z., Abu Bakar, J., Mohsin, F. H., & Md Isa, N. (2018). artificial intelligence, smart contract and Islamic finance. *Asian Social Science*, *14*(2), 145.
Mijwel, M.M. History of artificial intelligence. *Comput. Sci. Coll. Sci*., 1–6.
Mookerjee, I. (2017). Shariah compliant robo advisor to use AI. Retrieved October 20, 2019, from https://citywireasia.com/news/shariah-compliant-robo-advisor-to-use-ai/a1064772
MyFinB. (2019). Picking strong Shariah compliant stocks with. Retrieved November 12, 2020, from https://myfinb.com/press-release/picking-strong-shariah-compliant-stocks-with-a-i/
Bach, M.P., Krstić, Z., Seljan, S., & Turulja, L. (2019). Text mining for big data analysis in financial sector : a literature review. *Sustainability*, *11*(1277), 1-27.
Rahman, A. (2019). Opportunities and threats of Shariah-compliant robo advisory. the case of Wahed Invest. Retrieved October 15, 2019, from, https://www.grin.com/document/540407
Reid, S. G. (2019). Algorithmic trading system. Retrieved from, https://www.investopedia.com/terms/a/algorithmictrading.asp
Ramaswamy, S. (2017). How companies are already using AI. Retrieved October 15, 2019, from https://hbr.org/2017/04/how-companies-are-already-using-ai
Schmelzer, R. (2019). 5 benefits of AI in the banking industry. Retrieved October 14, 2019, from https://searchenterpriseai.techtarget.com/feature/AI-in-banking-industry-brings-operational-improvements
Tabash, M. I., & Dhankar, R. S. (2018). The relevance of Islamic finance principles in economic growth. *International Journal of Emerging Research in Management and Technology*, *3*(2), 49–54.
Tan, X., Chng, C. B., Duan, B., Ho, Y., Wen, R., Chen, X., & Chui, C. K. (2017). Cognitive engine for robot-assisted radio-frequency ablation system. *Acta Polytechnica Hungarica*, *14*(1), 129–145.

Times, N. S. (2019). Ethical code needed for AI. Retrieved November 12, 2020, from https://www.nst.com.my/opinion/columnists/2018/11/435928/ethical-code-needed-ai

Tuomi, I. (2018). The impact of artificial intelligence on learning, teaching, and education. Policies for the future. JRC Science for Policy Report. Retrieved October 14, 2019, https://publications.jrc.ec.europa.eu/repository/bitstream/JRC113226/jrc113226_jrcb4_the_impact_of_artificial_intelligence_on_learning_final_2.pdf

Wahed Invest. (2017). The halal investing guide. Retrieved October 4, 2019, from https://journal.wahedinvest.com/the-halal-investing-guide/

Wang, P. (2014). What do you mean by "Artificial Intelligence"? *Frontiers in Artificial Intelligence and Applications*, *171*(1), 362–373.

Zavadskaya, A. (2017). Artificial intelligence in finance : forecasting stock market returns using artificial neural networks. Retrieved October 14, 2019, from https://helda.helsinki.fi/dhanken/bitstream/handle/123456789/170154/zavadskaya.pdf?sequen

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 79-88
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Takaful, Zakat and Waqf Instruments in Ensuring Holistic Senior Citizens Program Development in Malaysia

Rusni Hassan[a*], Adnan Yusoff[b], Asral Widad Ahmad Asnawi[c], Ieman Sofiyya Adnan[d]

[a]*IIUM Institute of Islamic Banking and Finance, Malaysia*
[b]*Universiti Tenaga Nasional, Malaysia*
[c]*Pusat Jagaan dan Pendidikan Wargaemas Darul Insyirah, Selangor, Malaysia*
[d]*Kulliyyah of Islamic Revealed Knowledge, IIUM, Malaysia*

[*]*Corresponding author: hrusni@iium.edu.my*

Abstract

Malaysia will face the phenomenon of aging nation in 2040. In 2020 alone, the elderly in Malaysia is expected to reach 3.21 million people. The current of modernization greatly changes the structure of the Malaysian family whereby children are not able to take care of their old parents due to high demand of work and life. The work culture in Malaysia demands that employees to put priority on works and thus less focus on their family and elderly parents. Not only that the work opportunities that are mainly based in the cities and central areas require the young to travel and migrate far from their parent's residence, leaving the elderly parents unattended. This phenomenon requires urgent attention and consideration from the government and relevant bodies to plan for the future of the elderly Malaysian. This paper aims to first, appraise the role of Takaful, Waqf and Zakat in helping and supporting the elderly or senior citizens in Malaysia. Second is to propose Takaful, Waqf and Zakat as instruments to provide financial assistance and protection to the elderly community. Third is to propose how these three instruments can be integrated for the utmost protection of policy holders and their beneficiaries when they reach the golden age.

Keywords: Takaful, waqf, zakat, elderly community, protection

1. Introduction

The structure of the formation of the Islamic family is a complete and unique system in which Shariah has built a system of internal safety or safety net in an orderly and manner from the initial phase of birth, adolescence, adult and the elderly until a person dies. This safety net[1] starts from the construction and formation of Muslim as individuals, families and community where they need to be equipped with comprehensive knowledge related to the tasks and responsibilities that will be faced throughout life in this world. Adopting Shariah system or guidance results into a birth of a child who is pious, virtuous, polite and responsible that nurtures a happy family. It is always a parent's wish that their child is obedient, respectful, and caring for them at any times. In this situation, parents no longer feel worried about their future, especially at their old age because they will be protected and cared by the children.

Success in building a prosperous family will provide assurance to the entire community, including the elderly. Unfortunately, there are situations that put this safety net in an alarming situation. The challenges that faced by children nowadays result to the inability of the children to provide good care and services for their old parents. The millennial life-style of that prefers a small family member and thus limiting the number of children in their marriage is one of the reasons for the defect of such safety net. Studies such as Modig et al. (2017) found that frail old people without children have less social support and a less robust network for independent living compared to old people with children. Another contributing factor is the country's aims to be a developed country has pushed government to focus on agendas in improving the social standard of living

Article history:
Received 14 December 2020
Revised 18 December 2020
Accepted 22 December 2020

of society and thus demands involvement of women in the economic development of the family is to this defect. According to Aishah and Katiman (2012), children are now busy with their own education, career and family. The demands of education, career and family have forced some children to migrate to other districts, states or countries. Therefore, this situation becomes an obstacle for them to take care on the needs of their parents fully.

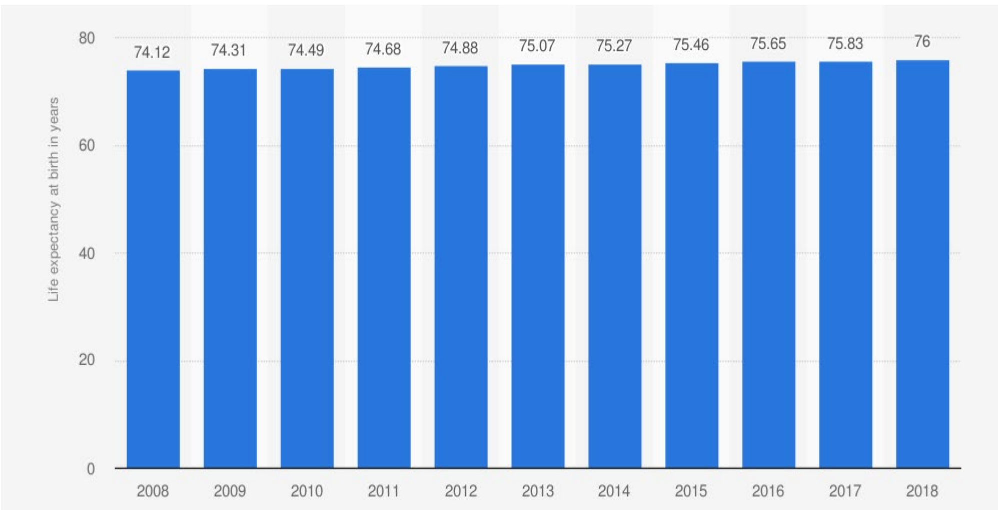
Therefore, the responsibility of maintaining the well-being of the elderly can no longer be fully borne by the children alone, but requires the involvement of other parties. Various positive and proactive actions have been taken by the government as well as the responsible bodies for this purpose in the form of physical infrastructure development such as nursing homes, health care services and so on.

2. Senior Citizen and Current Challenges

Looking at the current developments where family ties are getting weaker and children are no longer able to look after their old parents, require urgent attention of individuals to make their own preparation for the old age as there are no guarantee facing their futures. At the same time, the responsibilities of taking care of the elderly are now falls in the hands of society, related institutions and also the government.The situation will get worse if there are no action and preparation taken by the government or the private sector. In 2018, Malaysian population is estimated at 32.4 million people with an annual population growth rate of 1.1 percent. Studies have shown that Malaysian population aged 65 years and over (old age) is increasing. In 2017, the percentage was 6.3% and increased to 6.5% in 2018; while the percentage of the population under 14 (young age) in 2018 decreased from 24.1% in 2017 to 23.8% for the same period. Meanwhile, the percentage of the population aged 15–64 years (working age) increased from 69.6% in 2017 to 69.7% in 2018.

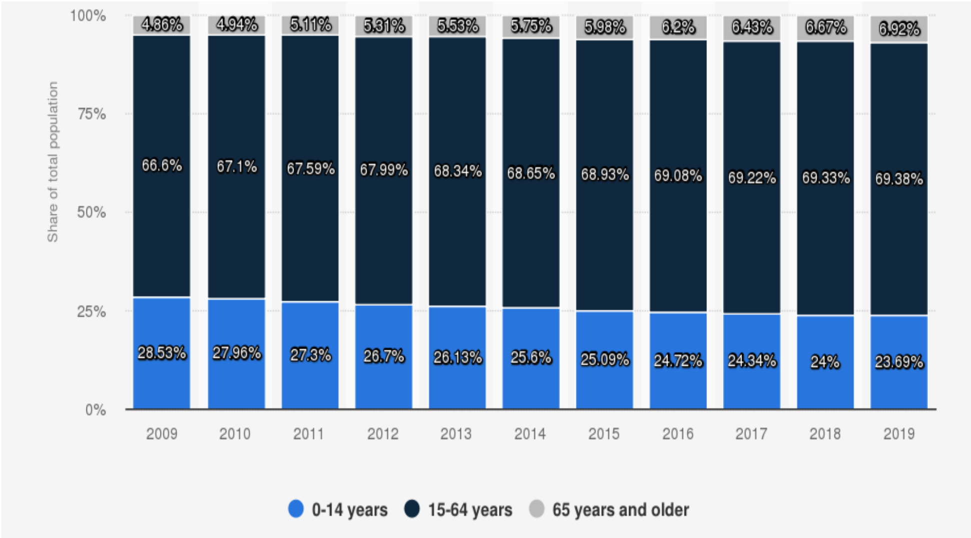
The national average life expectancy in 2018 was 72.7 years for men and 77.6 years for women, compared to 63.1 years for men and 66.0 years for women in 1966. This growing average life expectancy show that the elderly population aged 60 years and above reaching 15.3% by 2030. The aging phenomena will present a great challenge in the future. For that, a thorough preparation process needs to be done by various parties to deal with the situation. The following Figure 1 and Figure 2 illustrate the life expectancy at birth and and age structure of population in Malaysia.

Figure 1: Malaysia - Life Expectancy at Birth (2008-2018)



Source: Statista (2020)
https://www.statista.com/statistics/318682/life-expectancy-at-birth-in-malaysia/

Figure 2. Malaysia - Age Structure (2009-2019)



Source: Statista (2020)
https://www.statista.com/statistics/318729/age-structure-in-malaysia/

3. Takaful, Zakat and Waqf as a Safety Net for Senior Citizens

Takaful, zakat and waqf are the forms of Islamic financial instruments that have been in the Islamic treasury since the beginning. The development of the Islamic financial system has shown that this Islamic financial instrument widely used in its practice and operation to provide services to the community and the country. In the context of the relationship between takaful, zakat and waqf with the elderly, it does not involve a direct relationship where the takaful instrument refers more to ‘tools’ or vehicles that can bring certain assistance to the elderly. This is because takaful instruments are basically a concept of helping each other while zakat is a financial instrument in the form of obligatory contributions given by those who are capable to those (*asnaf*) in need to ensure the occurrence of economic balance in a society. Similarly, waqf is a financial instrument in the form of property contributions for the benefit of others whether for a particular person or general. These three instruments have a common purpose which is to help others.

3.1.1 Takaful

The essence of takaful revolves around mutual assistance, protection, indemnity, solidarity, and sharing liabilities among the participants (Engku Ali et al., 2008). The concept of takaful refers to the assistance that is provided by groups of participants to the afflicted participant. The agreement between these participants is based on the concept of *iltizam bi al-tabarru’* (commitment to contribute) that lead to the formation of takaful fund. This takaful fund is managed by the takaful operator on behalf of the participants (funders) for the purpose of paying compensation to the afflicted participants (Nazarov and Dhiraj, 2019). It is significant since Islam also encourages its followers to work together for the common good, assist one another in hard time while ensuring that one’s life and property are secured. This is mentioned in Quran, in Surah al-Ma’idah verse 2:

وَتَعَاوَنُوا عَلَى الْبِرِّ وَالتَّقْوَىٰ ۖ وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

“And cooperate in righteousness and piety, but do not cooperate in sin and aggression”.

3.1.2 Zakat

Zakat literally means holy, good, blessing, growing, and expanding. It is called zakat, because it contains the hope to receive blessings, purify the soul and nurture it with various virtues. Zakat is the third pillar of Islam and is a major source of economic organization in Islam. It is a mandatory payment that must be paid by every member of the Muslim community who meets certain conditions no matter what the circumstances as what have been mentioned in Quran, Surah al-Baqarah verse 43:

وَأَقِيمُواْ الصَّلاَةَ وَآتُواْ الزَّكَاةَ وَارْكَعُواْ مَعَ الرَّاكِعِينَ

"And establish prayer and give zakah and bow with those who bow [in worship and obedience]".

Zakat collection is to be paid to specific group of people known as *asnaf* as stated in Quran, Surah Al-Taubah, verse 60:

إِنَّمَا الصَّدَقَاتُ لِلْفُقَرَاء وَالْمَسَاكِينِ وَالْعَامِلِينَ عَلَيْهَا وَالْمُؤَلَّفَةِ قُلُوبُهُمْ وَفِي الرِّقَابِ وَالْغَارِمِينَ وَفِي سَبِيلِ اللّهِ وَابْنِ السَّبِيلِ فَرِيضَةً مِّنَ اللّهِ وَاللّهُ عَلِيمٌ حَكِيمٌ

"Zakah expenditures are only for the poor and for the needy and for those employed to collect [zakah] and for bringing hearts together [for Islam] and for freeing captives [or slaves] and for those in debt and for the cause of Allah and for the [stranded] traveller - an obligation [imposed] by Allah. And Allah is Knowing and Wise".

Based on the Quranic verse mentioned, there are 8 categories of beneficiaries that eligible to receive zakat. These 8 categories include: (i) *fuqara* - the poor meaning, low-income or indigent, (ii) *masakin* - the needy, meaning someone who is in difficulty; (iii) *amil* - zakat administrators, (iv) *muallaf* – someone who has just converted to Islam, (v) *riqab* - those in bondage (slaves and captives), (vi) *gharimin* - the debt-ridden, (vii) *fisabilillah* - in the cause of God, and (viii) *ibnus sabil* - the wayfarer, meaning those who are stranded or traveling with few resources.

Zakat forms a co-operative society, acts as an insurance company and savings fund of the Muslim community. Therefore, it acts as an additional capital by the community to help the unemployed, the poor, the orphans, the widows, the disabled, the ill, and others. It is an important social insurance for the Muslim community including the elderly who falls under the category of asnaf.

3.1.3 Waqf

Waqf is an act of dedicating a corpus of property or financial assets for the cause of Allah s.w.t. The property or assets for waqf are permanently given or transferred to Allah but the benefits are dedicated to virtuous causes such as the poor, sick and other marginalized segment of the society. In the history of Islamic civilization, waqf had played a predominant role as one of the foundations to build the community especially in providing the basic needs and infrastructure to the society. Waqf has significatly contributed to the alleviation of poverty and enhance welfare in the society through development of infrastructure in education and health care, water supply, highway facilities and many others. Among the historic contribution of waqf are the construction of the Quba' mosque and the Prophet's mosque in Medina, Azhar Al-Syarif University in Egypt and many others (Abd. Latif et al., 2008). Similar with sadaqah and infaq, waqf is a kind of voluntary charity which is highly encouraged in Islam. It is endowed for charitable purpose in pertuity and stands out as one of the greatest accomplishments in the history of Islamic civilization (Mochammad Arif, 2014). Allah s.w.t. has stated in Quran, Surah Ali Imran verse 92:

لَن تَنَالُواْ الْبِرَّ حَتَّى تُنفِقُواْ مِمَّا تُحِبُّونَ وَمَا تُنفِقُواْ مِن شَيْءٍ فَإِنَّ اللّهَ بِهِ عَلِيمٌ

"Never will you attain the good [reward] until you spend [in the way of Allah] from that which you love. And whatever you spend - indeed, Allah is Knowing of it."

Waqf as a financial instrument in Islam has a great potential in economic development of a nation in providing public infrastructures including the ones that are essential for the protection of the elderly.

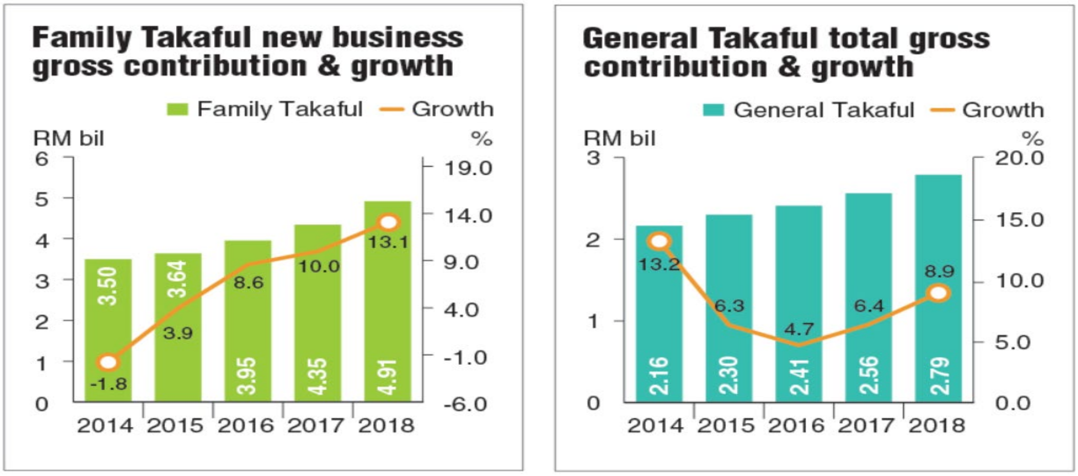
3.2 The Potential of Takaful, Zakat and Waqf as a Safety Net for Senior Citizens

The significance of takaful, zakat and waqf being the financial instruments that are heavily loaded with the elements of charitable, social contribution and mutual cooperation offer big potential to be structured as a mechanism to protect the elderly citizens. This section explains the present issues and challenges of these instruments and also explores their potential in providing the safety net to the elderly especially from financial perspective.

3.2.1 Takaful as a Safety Net for the Protection of the Elderly

Malaysia is one of the leading countries recognized as an Islamic finance centre for product innovation and operational best practises including takaful (EY, 2015). Malaysia takaful market has shown a remarkable growth since its introduction in Malaysia and expected to have prominent growth in the upcoming years. The following Figure 3 shows the gross contribution and growth of family and general takaful from 2014 to 2018 (The Edge Market, 2019).

Figure 3: Family and General Takaful (Gross Contribution and Growth)



(Source: The Edge Market, 2019)

Notwithstanding all the achievement in takaful markets, and the total of 16 takaful operators offering products and services to the Malaysian community (Source: BNM Website), there is a lack of attention to the pressing matters of Malaysian ageing phenomenon. Despite all of the existing takaful products in the market, there are very scarce takaful products that being offered to the elderly. Browsing through the takaful operators' website, there are only two takaful companies that offer such a product that are Zurich Takaful and Great Eastern Takaful. Interestingly, there are few takaful products for the protection of elderly that have been offered by the state of Johor, Kelantan and Selangor (Table 1).

Indeed, this is a serious matter that needs to be urgently addressed by the takaful industry in Malaysia. Due to the ageing phenomenon facing the country, having any type of assistance for the senior citizen is very much important (Arokiasamy, 1999). Hence a proactive endeavour needs to be done by every layer of the society. This includes the takaful market industries. The takaful industry must offer more takaful products for the elderly. This will ensure the protection of the elderly is very much guaranteed considering the risk that may occur to them i.e. medical expenses, loss of income source, weakening family ties, and more. It is timely for the takaful players to explore the waqf-based takaful especially for the protection of the elderly. Simultaneously, the government also play an important role to ensure the success in giving better protection for the elderly by ensuring that all Malaysian citizens subscribe to a takaful policy for that purpose. If need be, this can be a mandatory policy for all without exception. As a result, everyone will be protected of their life and need not to worry about their financial, healthcare or place to stay when they are old. Consequently, the burden of every layer of society and the government will be lessened. In this context, the takaful players have tremendous opportunity to provide a safety net for senior citizen, carrying out the responsibility as a ‘tool’ in protecting the elderly.

Table 1: Takaful Products for Senior Citizens in Malaysia

Takaful Company	Type of Takaful	Eligible Age to Purchase
Zurich Takaful	Senior Gold[2]	Minimum and maximum age limits for the life assured are set from 50 to 80 years old (last birthday) respectively.
Great Eastern Takaful	I-Great Harapan plus[3]	The minimum age at entry is 19 years ANB and the maximum age at entry is 70 years ANB.
	I-Great Ameen[4]	The minimum age at entry is 45 years age next birthday and the maximum age at entry is 75 years age next birthday.
NA	Skim Takaful Warga Emas (Kerajaan Negeri Johor)[5]	Applicant aged between 60 to 69 years old.
NA	Kifaalah (Kerajaan Negeri Kelantan)	The minimum age at entry is 60 years old.
NA	Skim Mesra Usia Emas (Kerajaan Negeri Selangor)[6]	The minimum age at entry is 60 years old.

(Source: Respective Institutions’ Websites)

3.2.2 Zakat as a Safety Net for Protection of the Elderly

The institutions of zakat in Malaysia are unique as they are placed under the control of Islamic Religious Council (IRC) of each state. The zakat institutions have been set up to perform the duty of collecting and distributing zakat funds (Ahmed and Zainuddin, 2017). Empirical evidences indicate that zakat collection in Malaysia has been increasing from year to year. Nevertheless, recent studies revealed millions of zakat funds are not distributed to the eligible recipients. The studies show that the performance of zakat distribution is fairly low compared to zakat collection (Ahmed and Zainuddin, 2017). Lembaga Zakat Selangor, for an example, has reported the increased in total collection of zakat to RM389.1 million in 2019 compared to RM375.1 million in 2018. In contrast, the total zakat distribution declined from RM370.6 million in 2018 to RM364.8 million in 2019[7]. This inefficiency of zakat distribution can be enhanced by enhancing the administration and management of zakat institutions.

In addition to the prior issues on zakat collection and distribution, another crucial issue also rises on the aspect of the receiver of the zakat. Certain criteria are set by the authority to ensure zakat is channelled to the rightful *asnaf*. Nevertheless, there are still defects in the management when there is a lack of disclosure to the public by the authority. Lack of awareness among the people is one of the contributing factor causing zakat did not reach the targeted people. Despite the existence of annual report by the zakat institutions which has already stated the distribution to *asnaf*, there are no detail and specification on the categories *of asnaf*. The detail report helps public to know the detail distribution of zakat to the individual category of *asnaf*.

Moving forward, the administration of zakat also need to be improved and this includes the ability of zakat collection centres to identify those who are obliged to pay zakat and to trace down the prospective zakat payers. Reports made by the PPZ/MAIWP in 2010 shows that the number of Muslims living in Selangor is approximately 2 million people but number of zakat payers is only around 160,000. For this purpose, the authority needs to make some changes to improve the method of collecting zakat as people nowadays still lack awareness on zakat (Ab Rahman and Najib, 2012).

Another aspect that can be improved is on the type of assistance provided by zakat institutions. For instance, in Malaysia the approaches used in distributing zakat is by providing fund for economic development and these include micro financing, providing free financial assistance to *asnaf*, funding the NGOs[8], providing fund for the social and education development (Zainal et al., 2016). Despite the funding, there is still no specific zakat instrument to assist and provide care for the senior citizen. Therefore, a specific zakat fund allocated particularly for the elderly need to be generated. The zakat for the elderly is not necessarily need to be in form of cash, it could also be in the form of building the facilities that can accommodate the senior citizen, such as providing health care services which are needed by the elderly.

3.2.3 Waqf as a Safety Net for Protection of the Elderly

Waqf is a financial instrument in the form of property contributions for the benefit of others either for a particular person or general public. Similar to takaful and zakat, waqf is also one of Islamic financial instrument that generates the economy whilst ensuring the benefits accrue to certain parts of the society (Mochammad Arif, 2014). Similar to zakat, the ruling concerning waqf institutions in Malaysia is subject to each state authority.

Despite the potential of waqf as one of the significant Islamic financial instruments in generating economic activities, there are still issues regarding the aspect of its property management. The Department of Waqf, Zakat and Haj (JAWHAR) has issued the statistics that in 2010 there were 11,511 hectares of waqf land worth RM116,441,667 in Malaysia. However, only 0.72% of the land was developed. Another issue is that Muslims are now inclined to endow cash for waqf instead of immovable assets (such as land). Having the corpus of waqf in the form of cash, it is vulnerable to mismanagement and corruption. Undoubtedly, waqf institutions that are professionally managed and well-governed can significantly contribute towards improving the welfare, standards and quality of life of many especially the beneficiaries (Omar et al., 2018).

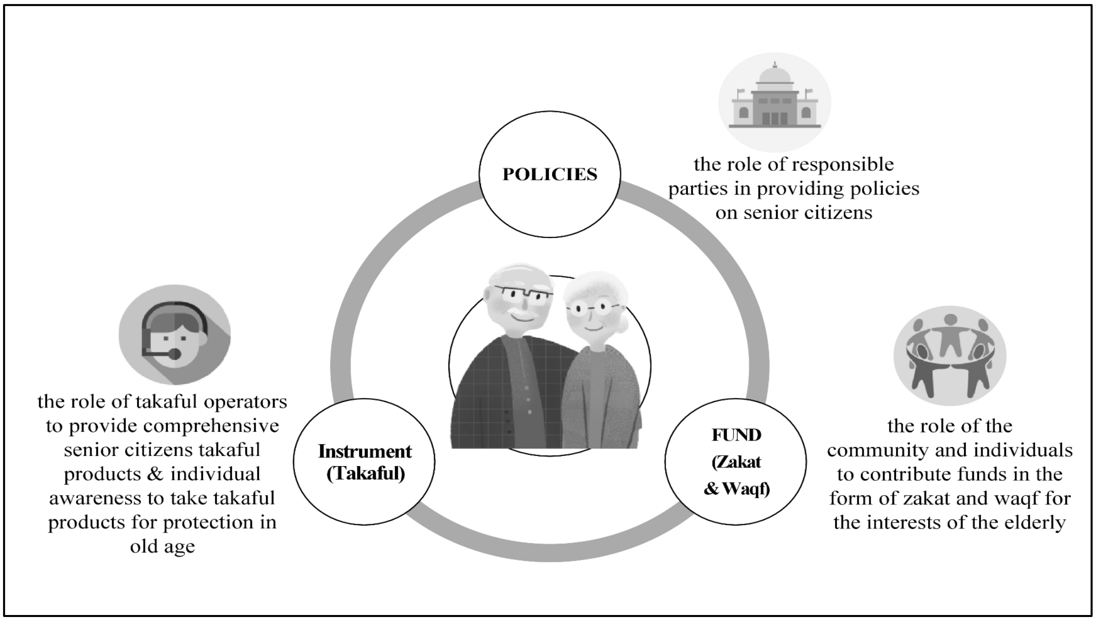
Waqf also offers good opportunity as a financial tool for the protection of the elderly. The frozen waqf property and land need to be revived for the benefit of the community and the elderly. There is an urgent need for land utilization to be used for the construction of home of the elderly. Reviving the waqf land for this purpose is urgently sought. In addition, the cash waqf contributed by the donors can be used to cover the expenses for the construction of the elderly homes or health centres and other facilities for them.

Acknowledging the constraint in the waqf administration which is held by each state IRCs, the related waqf authorities are urged to facilitate such an initiative by lowering down the barriers of restrictions imposed on waqf related matters; and the *muftis* are expected to exercise good contextual *ijtihad* on waqf for the benefit (*maslahah*) of the community especially the elderly.

4. Recommendations

Having explored the potential of takaful, zakat and waqf in providing the safety net for the elderly, this paper recommends that there are three constitutive elements that must be established to provide a comprehensive safety net for the protection of the elderly. Figure 4 below illustrates the recommendations.

Figure 4: Recommendations (Policies, Takaful, Funding)



Authors' own

(a) The policy on elderly
The government or relevant authorities are required to come out with the policies to safeguard the life of the elderly in the country. This policy may include the imposition of takaful policy subscription whereby all citizens are required to take the takaful or insurance policy for the protection of their elderly life. For working citizens, the takaful or insurance policy can be subscribed through their respective salary deduction or can be taken from their EPF contributions. For the non-working citizens, the government needs to provide special funds to provide them with the takaful or insurance policies.

(b) Takaful products for elderly
The takaful providers need to offer suitable products for the protection of the elderly. Besides the existing product structure which is based on *Wakalah* and *Mudarabah*, the potential of Takaful Waqf is also to be explored. The policy's benefit must include among others; the stay in the identified elderly homes, day care and medical expenses. The policy holders will enjoy the benefit upon their retirement i.e. 60 years old whereby they may choose to stay at designated homes or otherwise, they may claim for the surrender value in the form of cash in the case where they decided to stay with their family members. The marketing strategy of this product has to be aggressively done so that the public is aware on its importance.

(c) Funding
Providing a comprehensive protection or safety net for elderly requires a big fund. The elderly requires good facilities such as home or care centers, healthcare, education and other facilities to ensure that they continuously enjoy good quality of life in their golden age. As such, it is recommended that zakat and waqf instruments are to be utilized for the above purpose. In addition of the government funding, zakat and waqf fund can be the added financial assistance in providing the required facilities for the elderly. Zakat institutions need to allocate certain amount from the zakat collection to be distributed to the elderly homes and care centers especially for the elderly who are poor and disabled. However, for the elderly who are not under this category, the rulings on *asnaf* of zakat under *fisabilillah* may be extended to include this category of people. In addition to zakat, waqf can also contribute to the required fund. Frozen waqf asset may be revived to build elderly care centers and homes; whereas cash waqf may be used to cover other related expenses such as administration, maintenance and services. Suitable waqf programme for the public to contribute or donate are to be launched through crowd funding, salary deduction, bank account deduction and the like. The corporate bodies can also contribute to waqf as part of their Corporate Social Responsibilities (CSR) activities.

These three components are essential in providing the safety net for the elderly especially in the context of takaful, waqf and zakat. As Islamic financial instruments, the potential of these three instruments are to be explored to the most. The relevant authorities are urge to collaborate; the government is to provide support by issuing the suitable policies; and the public are also be made aware on the importance of this safety net and protection for their elderly life.

5. Conclusion
Malaysia will become an aging population country by 2035. With only about 15 years to go, how prepared is Malaysia in handling issues related to aging population? With that in mind the Malaysian government has to ensure decent employment as well as awareness programmes and services for the young, while at the same time, providing necessary assistance of life options for the elderly. There is an urgent need for a better support system that is affordable for the senior citizens of the country. Support extended to senior citizens must ensure that their dignity is preserved and a reasonable quality of life is assured. After all, they contributed to the nation in their prime hence it is the social responsibility of the nation to provide adequate assistance for the elderly.

The growing need for care of an aging population requires adequate policies by the government. Currently the government has implemented numerous policies for the betterment of the aged society; however, there is much more to be achieved especially in funding aspects. As such, it is timely that the great potential of takaful, zakat and waqf are to be explored to the utmost. Moving forward, this paper recommends that a Takaful Waqf model is to be developed for that purpose. This model combines the three significant financial instruments i.e. takaful, zakat and waqf, to provide comprehensive protection of the elderly.

End Notes

1. Safety net is defined as social or financial support to prevent poor outcomes for indigent people, families, or communities. In health care, the concept includes providing subsidized care for the uninsured, for the very young or the very old, for those with contagious diseases or those who cannot take care of themselves (Source: https://medical-dictionary.thefreedictionary.com/safety+net)
2. https://www.zurich.com.my/en/insurance-products/protection/for-my-parents/seniorgold
3. https://www.greateasterntakaful.com/content/dam/great-eastern/takaful/en/homepage/takaful-solutions/promotions/i-gr8-harapan/harapan-plus-brochure.pdf
4. https://www.greateasterntakaful.com/content/dam/great-eastern/takaful/en/homepage/about-us/news-and-events/i-great-ameen/i-great-ameen.pdf
5. http://www.pij.gov.my/takaful-warga-emas-negeri-johor-twenj/
6. http://e-mesra.yawas.my/
7. https://www.zakatselangor.com.my/informasi/laporan-aktiviti-zakat/#
8. https://www.mercy.org.my/donate/zakat/

Acknowledgement

The paper has been presented at the International Conference on Islamic Social Finance: Pandemic Crisis and Possible Solutions (Online) on 29th – 30th September 2020, organized by the IIUM Institute of Islamic Banking and Finance. We thank the reviewers and the Journal Editor for the constructive comments for further improvement of the paper.

References

Abd. Latif, A.Z., Ramli, A.H., Ismail, C.Z., Sulaiman, K., & Mohd. Daud, N. (2008). *Wakaf pengurusan dan sumbangannya terhadap pendidikan Islam di Malaysia*, Pusat Penerbitan Universiti (UPENA), UiTM: Shah Alam, 86-89.

Ahmed, E.A.E.S., & Zainuddin, Y. (2017). Evaluating zakat institutions performance in Malaysia. FGIC 1st conference on Governance & Integrity (2017) "Innovation & Sustainability through Governance", 3 – 4 April 2017, Yayasan Pahang, Kuantan, Malaysia.

Aishah@Eshah, M., & Katiman, R. (2012). Warga tua Melayu pinggir Wilayah Metropolitan, Selangor: pengalaman dan persepsi tentang diri. *Geografia: Malaysian Journal of Society and Space*, *8*(6). pp. 1-14.

Ab Rahman, A., & Najib, S. (2012). Zakat institution in Malaysia: problems and issues. *Global Journal Al-Thaqafah*, *2*, 35-41.

Arokiasamy, J. T. (1999). Malaysia's ageing population: challenges in the new millennium. *The Medical Journal of Malaysia*, *54*(4), 429–432.

BNM Website (Licensed Insurance Companies & Takaful Operators) https://www.bnm.gov.my/index.php?ch=li&cat=insurance&type=TKF&fund=0&cu=0

Engku Ali, E.R.A, Odierno, H.S.P., & Ismail. A. (2008). *Essential guide to takaful (Islamic insurance).* CERT Publications. Sdn. Bhd.: Kuala Lumpur.

EY. (2015). Malaysian Takaful dynamics. Retrieved from, https://www.malaysiantakaful.com.my/sites/default/files/2020-04/08-57cde02c-10fd-4335-9fe7-42aeb0fa4c67.pdf

Mochammad Arif, B. (2014). The significance of waqf for economic eevelopment. Retrieved September 20, 2020, from https://mpra.ub.uni-muenchen.de/81144/1/MPRA_paper_81144.pdf

Modig, K., Talbäck, M., Torssander, J., & Ahlbom, A. (2017). Payback time? Influence of having children on mortality in old age. *Journal Epidemiol Community Health*, *71*, 424–430.

The Edge Market (2019). Malaysia's 2019 takaful growth to stay moderate. Retrieved from, https://www.theedgemarkets.com/article/malaysias-2019-takaful-growth-stay-moderate#:~:text=The%20total%20family%20takaful%20business,grew%2011.8%25%20y%2Do%2Dy%20to%20RM4.&text=The%20general%20takaful%20industry%2C%20meanwhile,56%20billion%20in%202017.

Nazarov, I.K., & Dhiraj, N.S. (2019). A conceptual understanding and significance of takaful (Islamic insurance): history, concept, models and products a conceptual understanding and significance of takaful (Islamic insurance): History, concept, models and products. *International Journal of Innovation Education and Research*, *7*, 280-298.

Omar, A., Wan Zahari, W.Y., Mohamad, M., & Mardhiah, W. (2018). Current issue in corporate waqf in Malaysia. *Advanced Science Letters*. *24*, 3045-3051.

Zainal, H., Basarud-din, S.K., Yusuf, R., & Omar, Z. (2016). Managing zakat fund in Malaysia. *Journal of Global Business and Social Entrepreneurship* (*GBSE*), *1*, 46-53.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 89-100
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

The Realism of Islamic Economics: Abbas Mirakhor's Methodological Structure of Islamic Economics

Muhammad Sholihin[a*], Hafas Furqani[b]

[a]*Department of Islamic Economics, Institut Agama Islam Negeri (IAIN) Curup, Rejang Lebong, Indonesia*
[b]*Universitas Islam Negeri (UIN) Ar-Raniry, Banda Aceh, Indonesia*

[*]*Corresponding author: sholihin@iaincurup.ac.id*

Abstract

This study aims to explore and elaborate the structure of the Islamic economic methodology of Abbas Mirakhor. For this, the study applies an inter-textual approach to Abbas Mirakhor's works which are closely related to the methodology of Islamic economics. In addition, pairwise comparisons with texts that elaborate on the methodology of economics were also carried out, to see the genealogical structure of the methodology offered by Abbas Mirakhor. In essence, this study is able to identify the unique structure of the Islamic economic methodology introduced by Abbas Mirakhor which lies in two aspects. First is the intensification of the use of hermeneutics to produce substantive postulates of Islamic economics from sources of Islamic meta-framework (Quran, Hadith and *Turats*); while second, making substantive postulates as the foundation in verifying or falsifying economic experience. In conclusion, Abbas Mirakhor is considered as the bearer of Islamic economic realism.

Keywords: Islamic economic realism, meta-frameworks, archetype models, ultra-empiricism, moderate empiricism, *extreme apriorism*

1. Introduction

Islamic economics thought offered by Islamic economics scholars, undoubtedly has a different epistemological building. This difference exists, not only as a product of pairwise comparison with conventional economics but also internally compared to Islamic economic thought. It is no exaggeration to believe that Islamic economic thought introduced by Muslim economists is also full of differences and differentiation. This is understandable, because every thinker inevitably has world view in a unique paradigm and ideology of knowledge. It is just that the paradigm behind economic epistemology introduced by thinkers will always be connected or associated with ideas outside of themselves (Macknight and Medvecky, 2020). It also applies to the contemporary Muslim economist—Abbas Mirakhor. Not only the form of thought, but practically his Islamic economic ideas showed that the building of the Islamic economic methodology behind the economic theory introduced by Abbas Mirakhor was a product of social interaction, his ideas and daily life as an economist. It is just that, not many scholars who tried, and studied Abbas Mirakhor as an economist and put his Islamic economic theory and thought on the continuum of economic epistemological transmission. Because it examines the building methodology as well as the genealogical methodology it offers, it is important to be studied. This effort becomes important not only to recognize, but also to trace the roots and methodological traditions such as what is the foundation of Abbas Mirakhor's thought.

Abbas Mirakhor is an expert corroboration and becomes the iconography of the New Institutional Approach (New Institutional Economics) in Islamic economics. Some studies show this by convincing this view (Al-Daghistani, 2017; Askari et al., 2015; Khori and Yusdani, 2015; Morrison, 2019). The grouping of

Article history:
Received 10 August 2020
Revised 17 September 2020
Revised 19 December 2020
Accepted 21 December 2020

Abbas Mirakhor as the bearer of the idea of New Institutional Economics (NIE) is based on a set of argumentation. Abbas Mirakhor states that Islamic economics must be strengthened with an institutional legal foundation, in outline that Islam can comprehensively be promoted in Islamic economics (Khori and Yusdani, 2015). That is the basis of the argument of why Abbas Mirakhor is categorized as a New Institutional Economist (Mirakhor and Krichene, 2014). The development of the Islamic finance industry, complete with the complexity of the products it offers, must stand on the foundation of Islam. Because that institutional legality is needed for the product, consequently the financial industry does not run solely based on market reason alone (Arafah, 2019).

The institutional aspects and the legality of Islam towards the development of Islamic economics made Abbas Mirakhor a consistent bearer of NIE and introduced it through in-depth studies and explained his support for the idea of NIE implementation in Islam. However, there is another dimension that also stands out besides the bearer of the idea of the NIE, namely in the realm of methodology. Abbas Mirakhor more often demonstrates philosophical work as a realist-economy. This is marked by the intensification using mathematics and statistics in explaining the reality of Islamic economics and these include issues in Islamic banking and finance.

The question then, why does Abbas Mirakhor precisely offer an approach to economic realism to develop Islamic economic theory as a scientific discipline? What is the kind of epistemology tradition considered as a foundation of Abbas Mirakhor's idea? These questions are the main purpose of this article, while emphasizes this article also focusses on examining Abbas Mirakhor as an Islamic economic thinker. This article critically examines two things, namely: the structure of the methodology of Islamic economics offered by Abbas Mirakhor; and the epistemological tradition behind his thinking in Islamic economics. These issues are elaborated in two sub-theme of article—1) The complexity of Abbas Mirakhor's methodology; 2) Abbas Mirakhor purifies the realism economics. These issues are elaborated and the answers are formulated in this study. Then the literature study was selected to find the methodological structure and epistemological tradition of Islamic economics as outlined by Abbas Mirakhor in his works. Furthermore, the inter-textuality analysis is also applied as an instrument to understand the text and context of Abbas Mirakhor's work related to Islamic economic methodology.

2. Methodological Problems: Abbas Mirakhor in the Inter-textuality Path

The economic thought of Abbas Mirakhor is connected, or related to other ideas that are involved; or ideas that have come into contact with a character. Because ontologically, an idea and thought set forth in a text is a product of intense interaction between thinkers, philosophers of situations; needs; other goals and texts (Bazerman, 2003; Choudhury, 2018). This also applies to the text of Abbas Mirakhor's thought. Therefore, the inter-textuality approach can be chosen to find the methodological structure and epistemological tradition behind the thought of Abbas Mirakhor as an Islamic economic thinker.

The approach of inter-textuality itself is intended to examine the relation of the existing statistics in the text. How ideas are used and how they are positioned in relation to other thought and ideas (Al-Daghistani, 2017; Bazerman, 2003). This approach is based on the foundation of the thesis that the relationship of a thought expressed in the work, with tradition, culture and text must be broadly interpreted as synchronous and open the way for the assumption of quasi-intertextuality, that each writer has his own historical awareness in a distinctive tradition (Zegin, 2016). This framework is an effort to examine the thoughts of Abbas Mirakhor carried out by stepping on the mechanism of inter-textuality. This means, the text of Abbas Mirakhor's thought is needed not as a single text instead as an autonomous idea. His thinking nevertheless is a product of epistemic relations which lived throughout his life as an economist. There is contiguity of ideas; social; and intellectuals that Abbas did with other intellectual traditions. Thus, the style of thought offered by Abbas Mirakhor can be seen as an effort of falsification and verification, then leading to the synthesis of the building of Islamic economics. In this *locus*, NIE; and Abbas Mirakhor's version of Islamic realism needs to be understood.

Abbas Mirakhor's thought in the field of Islamic economics seems feasible to be positioned in the rules of the intertextuality approach, namely: first, a text contains various facts; second, the study of inter-textuality means analyzing the intrinsic and extrinsic elements of the text; third, the study of inter-textuality provides an equal perspective between the intrinsic and extrinsic elements of the text which are adjusted to the function of the text in society; fourth, in terms of the author's creative process, the presence of a text is the result obtained from other texts (Su'adah, 2019). Referring to this principle of inter-textuality, it is no exaggeration if the thought of Abbas Mirakhor is considered to have undergone a transformation (read: *not exactly evolution*) towards New Institutional Islamic Economics (NIIE), which is mature and concrete. At least, there is a transformation that occurs in the thoughts of Abbas Mirakhor. This transformation is a product of the intimate contact and interaction of Abbas Mirakhor on economic ideas and ideas other than Islamic economics, for example the tradition of NIE as the foundation of resistance as well as the development of neo-classical economic traditions.

In understanding Abbas Mirakhor's contact with other traditions, it is necessary to identify Abbas Mirakhor's individual transformation as a genuine thinker of Islamic economics. First is the performativity phase. This period is the growth period of Abbas Mirakhor. He was a successful student getting a bachelor degree; master and doctorate in economics from the Kansas State University, USA. Abbas Mirakhor's campus is famous as one of the oldest universities in Kansas, USA. In addition, the university has tradition in applied-science, consistently. Second is the period of horizon melting. This happened when Abbas Mirakhor joined the International Monetary Fund (IMF) (1984-2008). It is well known that the IMF is a think tank of the economic neo-liberalism community (Harmen, 2011). Third, the abstraction phase of the concept of NIIE. This period occurred when Abbas Mirakhor left the IMF and later joined INCEIF in 2010 as the first holder of INCEIF's Chair in Islamic Finance. These three phases that signify the transformation of Abbas Mirakhor's Islamic economic thought deserves to be interpreted as the *locus* of ideas and becomes a vehicle for thought that is formed from the inter-intellectual interaction carried out by Abbas Mirakhor. This can be identified from the style of work that was born, and the pattern of acceptance of intellectual authority which is used as a paradigmatic basis in his work and ideas.

Abbas Mirakhor is famous as an economist who is concerned with Islamic economics, since Abbas worked as an academia shortly after getting his Ph.D. Nevertheless, his intellectual career developed rapidly when he joined the IMF. There were twenty-one works by Abbas Mirakhor when he joined the IMF, in book form; journals and working papers. In this period, the most fundamental works of Abbas Mirakhor was the *Note on Islamic Economics* published by IRTI-IDB. It is considered fundamental, because in this work, Abbas Mirakhor introduces his initial views related to the Islamic economic paradigm. The paradigm of Islamic economics offers several propositions, namely: first, Islam has a view of how to organize political, social, and economic systems based on the building of ontology and epistemological propositions while considering their individual rights and collectivity. Second, defining an economic system as a collection of institutions (e.g. norms and rules of behavior) related to production, exchange, distribution, redistribution and defining institutions like the interpretation of Douglas C. North as rules and norms. Islam offers a different system in various aspects when compared with other schools of thought related to how an economy is organized. Third, the behavioral rules and norms of a conclusive Islamic economic system; strict; articulated analytics in a method intelligible with economists—empirically tested, and can also be a policy foundation or recommendation on the problems of modern society; fourth, currently the most important function of Islamic economics as a discipline is to build a precise language that brings to consensus among researchers by considering the meaning and function of terms, ideas, rules and norms (Mirakhor, 2007).

In his *Note on Islamic Economics,* Abbas Mirakhor shows a paradigmatic relationship with other Muslim economists. This is marked by some recognition of worldview; axiom; and Islamic economic theory put forward by scholars and other Muslim economists. For example, Abbas Mirakhor accepted the term proposed by Umar Chapra, the hibernation of Islamic economics due to the increasing attention of scholars of science and humanities in the Muslims world. This is marked by the achievement of linearly coupled, thinking interconnected offered by Muslim scholars regarding Islamic economics. Of course this helps to make critical reasoning about the economic system that is rooted in the European tradition (Mirakhor, 2007). In this context then, Abbas Mirakhor must be understood. The economic thought introduced, certainly did not spontaneously compound, but through a long process of interaction of ideas and philosophical foundations and co-existence with other economists' ideas, both from the conventional economist tradition, more specifically with Muslim economists themselves. Thus, the inter-textual approach is appropriate to be selected so that the link between the ideas of Abbas Mirakhor and other economists can be understood, and the final form is the identification of the epistemological structure of Abbas Mirakhor's economic thought, which can be formulated properly and accurately. Therefore, to understand the slices of tradition and the structure of the Islamic economic methodology of Abbas Mirakhor, it seems important to parse the mainstream as a variant of the developing methodology in economics.

3. The Methodologies of Economics: Paradigm and its Variance

Currently the Islamic economy is experiencing hibernation—a slowdown in knowledge. The slowdown became an economic discipline, due to the massive replication of positivistic economic traditions in the study of Islamic economics. In this situation, consistent efforts are found; and reformulating the epistemology of Islamic economics is important. At least in responding to this circumstance, there are many scholars of Islamic economics who strive to offer various forms of epistemology of Islamic economics. This is understandable, because until now, there has been no consensus regarding the epistemological building of the Islamic economy itself. In this context, it seems important to understand what and how the concept of an epistemology and the structure that accompanies it. However, understanding the epistemological structure of economics also becomes an integral process in its relation when it comes to understanding the structure of the production process of science, referring to Ludwig von Mises, who believes that economics is part of a general theory of human behavior and actions (Mises, 2003). This interpretation emphasizes that economics exists as something empirical from human economic behavior and actions. As a science, Uskali Mäki describes that economics as a product of social processes (Mäki, 2005). Mäki even believes that economics is the queen of social science (Mäki, 2005). This is understandable because economics is a product of the social processes carried out by humans, especially in relation to efforts to meet the needs of human life. In this *locus*, to understand the epistemological structure of economics, it seems important to understand epistemology in the meaning built by Robert Audi as a theory of knowledge; and theory of justification (Huemer, 2002). In this realm then the structure of economics needs to be parsed, and elaborated.

Economics, in the *locus* of knowledge theory, has a very complex dimension. In this case, the history of the epistemology of economics tends to be attributed to John Stuart Mill, who, according to some of his beliefs, that: (i) the relationship of economics with empirical science such as physics, on the one hand, and other non-empiricist sciences such as geometry, is not easily and completely parsed; (ii) epistemology, whether empirical or non-empirical science in general is always controversial to rely on; (iii) economics is more complex and difficult in the sense of epistemology, when morals and normative also form the basis of economics (Sagal, 1977). Nevertheless, the theory of knowledge and the justification theory of economics can be stretched into three paradigms of long, deep discussion, namely: ultra-empiricism; moderate empiricism and *extreme apriorism.*

In the process of producing economic theory, economists will always be on the three paths of schools (e.g. *ultra empiricism; moderate empiricism; and extreme apriorism*). In the tradition of ultra-empiricism, every human action is necessarily based on rational considerations (Machlup, 2009). Then every conclusion of economics must be based on that philosophical dogma. In addition, the mechanism verifications of economics are aimed at maintaining *politico-intellectual obscurantism,* which determines the tests to be chosen in proving the economic theory. In praxis, ultra-empiricism requires testing prepositions using fundamental assumptions in a theoretical system (Machlup, 2009). Understanding the framework of the tradition of ultra-empiricism, it is necessary to explore T.W. Hutchison's philosophical views. This will lead to mechanistic information, how ultra-empiricism works in the production of economic theory.

Regarding how ultra-empiricism works, T.W. Hutchison poured the answer in his work, *The Significance and Basic Postulates of Economic Theory* (1938). According to him, economics should ideally start from pure theory; and the framework of pure theory is not in the mechanism of investigating the sources of preposition validity. Instead, it is precisely to clarify the relationship of the preposition with the assumptions or postulates from which it originates. It also includes clarifying the assumptions of *ceteris paribus.* The end of all, this is to clarify the assumption by analyzing the key concepts such as equilibrium; expectations; sensibilities; rational conduct*;* and utilities (Hutchison, 1938). Briefly, the tradition of ultra-empiricism driven by T.W. Hutchison seeks to position the work of economic theory within the framework of pure theory, not in its function to validate prepositions. However, it does clarify the relationship between economic prepositions and economic reality. Of course this is different from the tradition of moderate-empiricism supported by Milton Friedman.

Uskali Mäki calls Milton Friedman as an economist who popularized the ideology of science, where the ideology provides instructions on how to study economics and how to organize academic life in general

(Mäki, 2009). Based on this philosophical view, Milton Friedman then produced many works, and one of them was *the Methodology of Positive Economics.* In the production of economic theory, Milton Friedman introduced 'positive economics' and this later became a tradition of studying economics, accompanying the tradition of ultra-empiricism. The tradition of positive economics emphasizes the principle of independence from positions of ethical justification and particular norms (Mäki, 2009). In John Naville Keynes's terms, positive economics is closely related to the 'what is'; not 'what ought to be' diction (Mäki, 2009). This philosophical framework provides a conclusion system that can be used to formulate correct predictions related to the consequences of various changes in economic reality (Mäki, 2009). This then aligns economics with physics and becomes an objective science.

For Milton Friedman economics, in fact, is related to human and researcher interruption as the subject of study (Mäki, 2005). This is certainly different from physics, between researchers and the subjects under study, as they are different and have no interrelation. Thus, physics is more objective. Nevertheless, Milton Friedman carefully and confidently offers a tradition of *moderate-empiricism,* and is supported by the paradigm of *positive-economics.* In this case, Milton Friedman asserted that the ultimate goal of *positive economics* is to build valid theories or hypotheses and meaningful predictions related to phenomena that have not been observed (Mäki, 2009). In this framework, the theory is valued as a substantive hypothesis, and it must be justified by the predictive power of various classes of phenomena to be explained (Mäki, 2009). Hence, the tradition of *moderate empiricism* is supported by the paradigm of positive economics that seeks to make economic theory a more substantive hypothesis, and can confirm the economic reality. As a rivalry, Ludwig von Mises and Lionel Robins introduce other methodological traditions, which are relatively different. They call it *extreme apriorism* and the philosophical view that underlies this tradition.

Another term from the apriorism methodology tradition is the epistemological justification of the a priori element(s) of economic theory and epistemological justification of the a priori element of economic theory. In this context, Scott Scheall laid the foundation of a priori economics (Scheall, 2017). Scheall began his methodology from a philosophical view that human action is a behavior that has a purpose (Scheall, 2017). Therefore, the procedure of economics is the application of the category of human action because it requires the deduction of praxeology to understand human behavior (Scheall, 2017). Scott Scheall convinced economic scientists to base their economic analysis on a general theory of choices and preferences.

The praxeological deduction offered by Ludwig von Mises is useful to solve the economic problems. In addition, it is also an alternative of the economic method in assessing a set of economic behavior and continues to be developed until present. However, the method of Ludwig von Mises has not been reviewed by Islamic economists whether it can be applied in Islamic economic studies as a method. This is understandable, because currently Islamic economics is actually being developed within the framework and style of the neo-classical economics. This is indicated by the adoption of positivism axioms in building economic modeling (Reuten, 1996). As a consequence, the development of an Islamic economic methodology is still trapped in accommodative efforts to conventional economic methods. However, it does not mean that the development of the Islamic economic methodology has stagnated. In fact, there are various efforts to show that the Islamic economic methodology is still being developed creatively and philosophically. In this context, then, an important question is formulated, namely: How is the latest development of Islamic economic methodology? Did the three traditions (ultra-empiricism; moderate empiricism; and extreme apriorism) grow in the epistemological structure of Islamic economics? Or rather, there is a transformation that differentiates Islamic economics from economics methodology. To understand these issues, it is necessary to put forward several methodological concepts that are currently developing in Islamic economic science. The following section discusses the variance of Islamic economic methodology.

4. The Variance of Islamic Economic Methodology

Islamic economy, admittedly, is indeed a process towards a scientific discipline. In this regard, there is no standard epistemological consensus in relation to the theories in Islamic economics (Haneef and Furqani, 2011). Uniquely, the dynamics and contestation of Islamic economic methodology has actually strengthened and expanded in recent decades. This led to the birth of several variations of Islamic economic methodology. Based on the existing literature, Islamic economic methodology can be categorized into three typologies.

The first typology is the tradition of Islamization of economics based on the neo-classical paradigm. In this regard, neo-classical economics was positioned as a framework and foundation of Islamic economic model. Therefore, it is easy to find a set of neo-classical assumption that systematically integrated into theories of Islamic economics. This stage is a result of the domination of neo-classical tradition (Arrow, 2016). Consequently, curriculum courses and economic education, research agendas, journals and massive publications are represented in the neo-classical economic tradition. It is essentially a part effort of Islamization economics. In connection with the Islamization of economics, the search for the influence of neo-classical traditions in Islamic economics can be traced to two methods, namely: (1) looking at intrinsic values in the narrative of economic theory — does the theory put forward by Islamic economics scholars contain values of neo classical intrinsic? This intrinsic value refers to the basic assumptions and axioms on which classical economic theory is built; (2) identify themes and assumptions associated with terms and assumptions that grow and develop in the neo-classical economic tradition (Arrow, 2016). In addition, another characteristic of the neo-classical economic tradition in relation to methodology is the very intense use of the Imre Lakatos[1] research methodology (Brahmachari, 2016). Referring to this indicator, the Islamization of economics carried out by Islamic economics scholars is also trapped in this neo-classical economic tradition.

Salman Ahmad Sheikh is a scholar who is concerned about integrating neo-classical economic traditions and Islamic economics. This is indicated by the application of intensification and abstraction of mathematical models in explaining economic reality. In addition, Sheikh's article titled *Examining Classical and Neo-Classical Theories of Development from Islamic Perspectives and Islamic Solutions to Contemporary Development Problems* (2013) serves as a sign that Sheikh is trying to critically integrate the neo-classical economic traditions and Islamic economics. It is just that this integration process is carried out very carefully due to its criticality (Shaikh, 2013).

The second typology of the study of Islamic economics is marked by efforts to qualify Islamic economics based on moral economics, but still provides a minimal portion of the neo-classical economic tradition. In relation to this, one of the scholars of Islamic economics who is concerned with this tradition is Mehmet Asutay. Through one of his articles, *Islamic Moral Economy as the Foundation of Islamic Finance* (2013), Mehmet Asutay laid down a system of Islamic moral economic philosophy and became the foundation of Islamic finance. According to Asutay, *Islamic Moral Economy* (IME) is a response to the failure of economic development in Muslim countries—both by capitalists, socialist and nationalist. The solution to this failure according to him is, to return to the authentic sources of Islam in order to build an economic model, and that are Quran and Sunnah (Cattelan, 2013). Mehmet Asutay was not the only Islamic scholar who supports the idea of Islamic economics based on moral economics, others like (Chapra, 1996, 2000); (Siddiqi, 1981); (Al-Sadr, 1987); (Khan, 1994, 2013) and (Naqvi, 1981, 1994) were also noted as laying the foundations of the Islamic moral economy in the modern era. They indeed tried to articulate the initial theoretical building for Islamic economic morals, which later became the basis of the ethical-religious foundation for Islamic banks and finance (Cattelan, 2013). This then encouraged Mehmet Asutay to formulate a methodology of Islamic moral economics which was relatively different from other methodologies adopted by Islamic economists who are partially attempt to construct Islamic economics as a science from empirical foundation.

Mehmet Asutay offers several methodological postulates of Islamic moral economics, namely: (1) as a form of resistance to the methodology of individualism in conventional analysis, the IME assumes that humans are as "altruistic persons" which are not only concerned with the individualism value system but also have social concern as the main prerequisite; (2) As the foundation of behavioral postulates, the IME assumes the existence of a God-conscious individual, where individuals: [a] try to meet their needs and self-interests while paying attention to social goodness, [b] carry out economic activities in a rational manner by always referring on Islamic boundaries based on the social environment and the end-day, and [c] effort to satisfy the utility, the individual will indirectly pay attention to maximizing social welfare well because it is an important part of gaining happiness in the afterlife; (3) in relation to institutional assumptions of IME in conventional analysis, especially in terms of accepting the doctrine that market mechanisms are an important component of the operation of IME, the market mechanism must work on a moral foundation to produce a

[1] Imre Lakatos is a Hungarian mathematician and philosopher. In the context of the philosophy of science, Lakatos is known as a philosopher who offers methodology for scientific research by which he refers as the epistemological structure for research. Lakatos published his work entitled *Criticism and the Methodology of Scientific Research Programs* (1968).

friendly environment system. This is however avoided in the system of socialism; and welfare state with the aim of getting high economic incentives (Cattelan, 2013). It seems that the relationship between neo-classical economic traditions and IME can be established, especially in terms of accepting the market mechanism as the best economic instrument.

The third typology is the methodological tradition developed by Abbas Mirakhor. To understand the epistemological structure of Islamic economics offered by Abbas Mirakhor, a careful reading of his works and studies are needed. According to Abbas Mirakhor, Islamic economics is a discipline that is concerned with issues such as: first, the behavioral structures guided by Islam, especially related to the allocation of economic resources, production, exchange, distribution and redistribution; second, the economic implications of the operationalization of Islamic principles; third, the policy recommendations to achieve an order that adheres to Islamic values, which lead to the actual economic convergence to an ideal economic system encouraged by Islamic values (Mirakhor, 2009). In order to build a theory from this concept, it is necessary to base the analysis on a critical paradigm built from axioms, propositions, and assertions related to the relationship between important elements of the concept with economic reality (Mirakhor, 2009). From this concept, it seems no exaggeration to mention Abbas Mirakhor as a pioneer of Islamic economic realism. The current study therefore is certainly based on the philosophical views of Abbas Mirakhor as outlined in his intellectual works related to the Islamic economics. Therefore, it is necessary to uncover philosophical views, assumptions and propositions which form the foundation of the Islamic economic methodology offered by Abbas Mirakhor, carefully and deeply.

5. The Complexity of Abbas Mirakhor's Methodology

Methodology is a specific part of a philosophy of science, which is often referred as epistemology. However, in epistemology, a set of intensively studied are knowledge theory, source of knowledge; application of knowledge and the scope of a science. Meanwhile, the methodology is more specifically related to how a theory is built and how to evaluate the theory (Haneef and Furqani, 2011). Referring to this concept, the elaboration of the methodology of Islamic economics offered by Abbas Mirakhor is concerned on the process of producing Islamic economic theory itself —a theory is built; the method consistently applied to produce Islamic economics theories.

Abbas Mirakhor radically elaborates on the Islamic paradigm, beginning his efforts by carrying out Islamic economic abstractions. According to him, Islam is a guidance system that functions as a method that can be used by humans; and the community to achieve material and non-material progress that consistently refers to effective rules and institutions (Askari et al., 2015). In this context, institutional framework of the Islamic economic system is built through the order of behavior defined from the Quran. Thus, the content and blueprint of Islamic economics is formulated through: 1) extraction of rules which describe the ideal Islamic economy and its economic implications from the Quran and Sunnah; 2) examining the institution in contemporary economics and determine the degree and level of deviation between institutional framework and the ideal Islamic economy; 3) offering policy recommendations that can bridge the gap between them (e.g. institutional framework and the ideals of Islamic economics). It can be understood that Abbas Mirakhor formulated in advance the ideal form of Islamic economics derived from the two main sources of Islam, namely the Quran and Sunnah (Askari et al., 2015), then encourages the existence of institutions that can discuss the ideal form of the economy. In this context, Abbas Mirakhor also interprets the importance of market in Islamic economy.

According to Abbas Mirakhor, the Islamic economic system is a market-based system, where the market must be seen as the most efficient and good mechanism for the allocation of economic resources such as production and consumption. Nonetheless, the efficiency of the market system should not be obscured by positioning the market as an ideology. To achieve market efficiency, the market itself does not deserve to be interpreted as the philosophy or foundation of the economic system, and is upheld as a supernatural in determining the efficiency of the economic system. Market efficiency can only be achieved if the market is run based on rules that are fully intended to protect economic actors (workers; producers; investors and consumers) and must be monitored by strict enforcement (Askari et al., 2015). These rules are built on the basis from the Quran and Sunnah. In this case, the Quran and Sunnah as categorized by Abbas Mirakhor, a meta-framework and archetype of economic rules. This further strengthens Abbas Mirakhor belief that the source of all Islamic paradigms originates from the Quran (Askari et al., 2015) as the Quran provides a framework of Islamic economics. Likewise in relation to epistemology, the Quran and Sunnah are the main sources of Islamic economic theory as both are sources of the foundation and order of the economic reality of Islam. As such, the Quran and Sunnah are called the meta-frameworks abstract, and they do not change. It is interpreted as a source the archetype model essentially providing universal-specific rules of behavior and the institutional structure needed for organizing a human society based on the immutable rules of meta-framework (Askari et al., 2015). In relation to this, the important questions which are worth asking, what are the methodological concepts offered by Abbas Mirakhor when extracting axioms—the basic Islamic economic philosophy of the meta-framework (e.g., the Quran and Sunnah) and instruments are used for the process.

Abbas Mirakhor introduces the use of the hermeneutic approach in formulating postulates, or Islamic economic axioms derived from the meta-framework — the Quran and Sunnah. According to Abbas Mirakhor, hermeneutics is applied by classical scholars in understanding texts. In relation to Islamic economics, there are many illustrations of the application of Islamic economic hermeneutics by Muslim economists (Mirakhor, 2007). For example, Umar Chapra in his book *The Future of Economics,* according to Abbas Mirakhor is full of illustrations of the application of economic hermeneutics. Likewise, Tajuddin and Rofie (2014) when explaining the order of the Quranic system, applied analysis in an inter-generational framework and inter-temporal framework. Efforts to produce economic theories from an Islamic perspective such as building Islamic assumptions about rationality, self-interest and human behavior through hermeneutics are important (Mirakhor, 2007). Briefly, Abbas Mirakhor actually used the hermeneutic approach to capture the Islamic vision of the economy. Hermeneutics is not only addressed Islamic meta-framework, but can also be used in other Islamic texts in the form of *Turats*—classical literatures written by Islamic clerics or *mujtahid* (e.g. scholarly writing on *fiqh*, ethics, philosophy, history of Muslim society, and history of thought). In addition, hermeneutics helps Abbas Mirakhor to formulate economic postulates that refer comprehensively to Islamic meta-framework.

Understanding Abbas Mirakhor from the concepts related to the sources of Islamic economic science, as to what Abbas Mirakhor built the structural methodology of Islamic economics, and its relationship with hermeneutics, is rather difficult to define in the epistemological tradition. This is normal because Abbas Mirakhor is a complex figure (Khori and Yusdani, 2015). Therefore, it is necessary to understand Abbas Mirakhor through his work entitled *Introductory Mathematics and Statistics for Islamic Finance* (2014). This work confirms its position as a Muslim economist who advocates the use of mathematics and statistics as tools in analyzing Islamic economics, especially in the study of Islamic finance. Mirakhor and Krichene (2014) state that to understand the ontology of Islamic finance, the scholars must have sufficient ability to operate mathematical and statistical calculations. This recommendation is understandable because Islamic finance activities like conventional finance are full of equations to calculate internal rates of return, replicating portfolios, structuring products, pricing assets, and calculating the cost or break-even points (Mirakhor and Krichene, 2014). Following this, it is natural to categorize Abbas Mirakhor as an advocate of Islamic economic realism since reading economic reality through numbers is a concrete form of realism. Explanation of the reality of Islamic economics through mathematical approaches, and statistics, may deliver Abbas Mirakhor as a Muslim-realist economist.

The complexity of Abbas Mirakhor as a Muslim economist is also seen when he parses and offers the ideal concept of Islamic economics. Abbas Mirakhor began his exploration by proposing the paradox of capitalism, to then offer the ideal concept of an economic system that refers deeply and revolutionarily to Islamic meta-framework —the Quran and Sunnah. Referring to the study put forward by Rima (2003) in which the author quoted "the paradigm of capitalism neo-liberalism cannot solve recurring economic crises, even the neo-liberalism reasoning is the part that triggers the crisis". In this context, Abbas Mirakhor composed the epistemological system of Islamic economics, which was relatively different from other Islamic economics scholars. Philosophically, Abbas Mirakhor explains the process of externalizing the Islamic economy as follows:

"The fountainhead of all Islamic paradigms is Quran. It provides the framework within which all relevant envisioned conceptions of reality find their source. This eternal source specifies the rules of behavior (institutions) applicable to all societies at all times. These rules are immutable temporally and spatially. The meta-framework specifies the immutable, abstract rules. The archetype model articulates the operational

form of these rules and demonstrates how these rules are operationalized in a human community. The abstract became operational in the hands of the human being who was the one and only direct recipient of the source of the meta-framework, Quran. Through the words and actions of this perfect human, the meta-framework given by the Creator in Quran was interpreted, articulated, and applied to the immediate human community of his time. The meta-framework specifies general universal laws, rules of behavior. The archetype model provides universal-specific rules of behavior and the institutional structure needed for organizing a human society based on the immutable rules of the meta-framework" (Askari et al., 2015).

Evidently, the Quran and everything derived from it becomes law for reality— unchanging; permanent and universally valid as an archetype and institutional fold for economic behavior. Therefore Islamic meta-frameworks—the Quran and Sunnah, should ideally be able to be converted into abstract and rules immutable. At this level two methodological processes are applied, namely hermeneutics as an effort to interpret and capture the Islamic value order; and economic realism as an effort to fabricate law for reality. This process naturally leads to the formulation of an archetypal model that articulates the operational form of the law for reality and demonstrates on how the rules are operated in the human community (Askari et al., 2015). In terms of the epistemology of economics as social science, how the structure of the IEM is offered by Abbas Mirakhor? It seems necessary to consider the structure of the methodology in the philosophical narrative of the epistemology of economics. This is aimed at identifying which parts of the structure of Abbas Mirakhor's Islamic economic methodology differs from the structure of conventional economic methodologies.

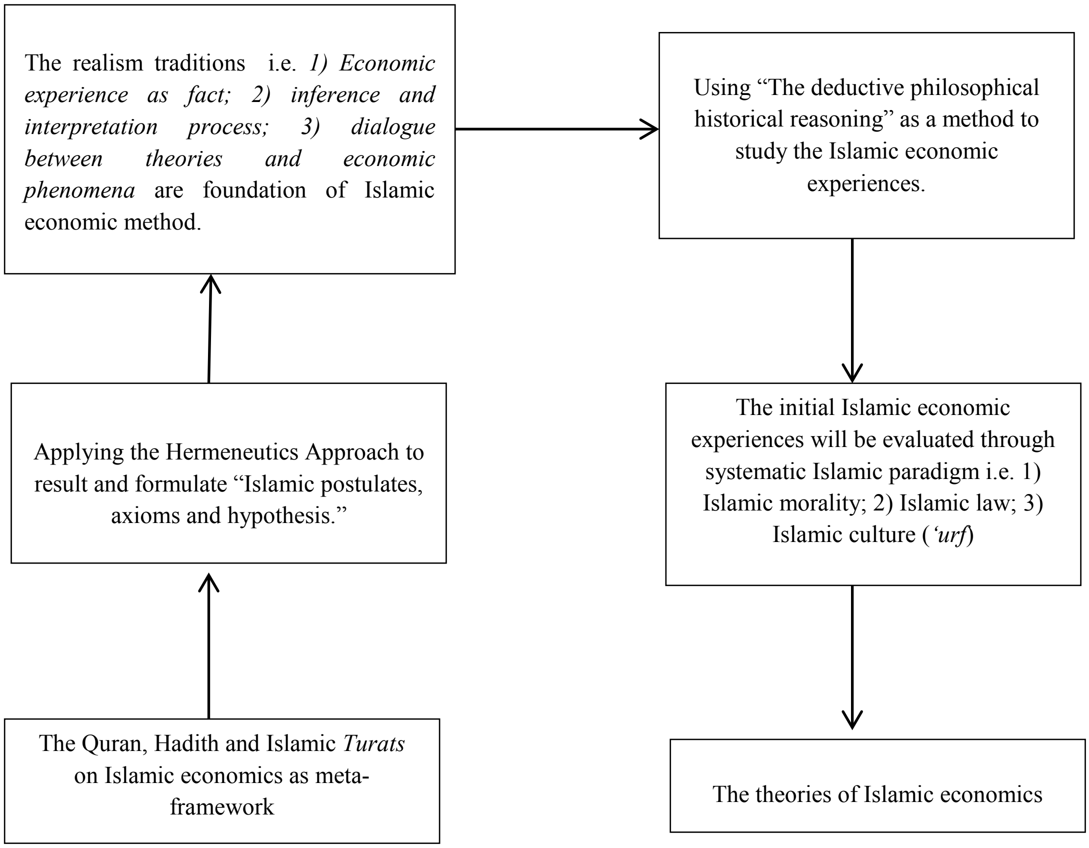
6. Abbas Mirakhor Purifies The Realism Economics

A main idea that can be offered when exploring economic thought and Islamic economic methodology offered by Abbas Mirakhor, specifically; Abbas Mirakhor is a Muslim economist who seeks to purify economic realism by incorporating a hermeneutic approach to the text of the Quran and Hadith especially in his efforts to formulate postulates, axioms and hypotheses related to Islamic economy. The current study explores the economic thought and Islamic economic methodology offered by Abbas Mirakhor and proposes that Abbas Mirakhor is a Muslim economist who seeks to purify economic realism by incorporating a hermeneutic approach to the text, especially in his efforts formulating postulates, axioms and hypotheses related to Islamic economy. The idea is illustrated as in Figure 1.

Abbas Mirakhor began his thinking through efforts to position the Islamic meta-framework —the Quran, Sunnah and classical literature of Islamic economics. The meta-framework is then understood and interpreted by the hermeneutic approach. The ultimate goal of applying this hermeneutic approach is to express Islamic values, and then becomes the foundation of Islamic economic postulates. Abbas Mirakhor illustrates this process through understanding the meaningful declaration of the Quran (2: 276), regarding the meaning of يمحق الله الربا و يربي الصدقات (*Allah destroys usury and fertilizes alms. And Allah does not like anyone who remains in disbelief, and always sins*). Muslim economists actually apply the hermeneutic approach to this verse, paying attention philosophically to the meaning of the words يمحق (*destroy*) and يربي (*grow*). This is an indicator that distinguishes the impact of usury and alms on the economy, especially for economic actors who involved in usury and alms. The meaning of this hermeneutic, the economist can create a Keynesian model to calculate marginal propensities for usury and alms itself (Mirakhor, 2007). From Abbas Mirakhor's explanation, it can be understood that hermeneutics serves as a catalyst for the postulates of Islamic economics from meta-framework sources. Then, the postulate is again empirically examined in the tradition of economic realism.

The tradition of economic realism itself is identified through a concept that refers to Tony Lawson, where a realist economist will see two methodological efforts, namely: interpreting and differentiating. These two will always be used as reasoning methodology for those who hold to the realm of economic realism (Lawson, 2003). Abbas Mirakhor ideas on the method of Islamic economics certainly can be categorized in the two reasoning. At the level of the use of hermeneutics against the sources of Islamic meta-framework, Abbas Mirakhor is actually doing an interpretation. When successfully building a postulate; and the Islamic economic model, Abbas Mirakhor is actually trying to give an emphasis that distinguishes Islamic economics from positivism economics. Abbas Mirakhor built it from Islamic meta-framework positioned differently (Khori and Yusdani, 2015) despite it being in the Keynesian economic model framework. Abbas Mirakhor makes the model built on his interpretation of Islamic texts as prima-postulate, and is not intended to be tested. Rather the model is positioned as the foundation of an evaluation of economic experience undertaken by economic actors. In this context, then Abbas Mirakhor can be categorized as an advocate of Islamic economic realism.

Figure 1: Abbas Mirakhor's Methodological Structure



Authors' formulation

In addition, by including a hermeneutic approach or an attempt to make a philosophical interpretation of the Islamic text, and then the results of that interpretation or exegesis is used to evaluate the economic experience. This can be interpreted that Abbas Mirakhor tried to purify the tradition of economic realism. Rather, Abbas Mirakhor is trying to convince the economic community, in understanding reality, it is not enough to state that economic reality is one-fold, and only recognize the reality of economic experience. However, there is a supra-normative reality, and it is sourced from Islamic meta-framework such as the Quran, Sunnah and *Turats (*e.g. intellectual works of Muslim scholars).

According to the tradition of economic realism, there are two aspects that concern to identify by the realism-economic society, namely: awareness; and the structure of social reality (Lawson, 2003). It is just that, in a different form, Abbas Mirakhor is also trying to find the intrinsic awareness (supra-consciousness) that is behind the Islamic text. To discover, and understand this, the hermeneutic approach was used by Abbas Mirakhor so that the postulate, and the economic model that comes from the meta-framework, can be the foundation of an evaluation of human economic experience. The substantive compounded model designation can be recognized as archetype models for Islamic economics and can be institutionalized as a solution to economic problems. Thus, the structure of Abbas Mirakhor's Islamic realism-economy differs from the tradition of ultra-empiricism; moderate empiricism; and extreme apriorism, which only recognizes empiricism as the foundation of Islamic economic methodology, in which the reality compounded by common sense is recognized as the main account of economic theory—in the meaning carried out by Abbas

Mirakhor of reality. The ultimate reality is actually, there are authoritative sources, or wealth legacy of Islam in the form of the Quran, Hadith and *Turats*. This ultimate reality determines the process of Islamic economics into a scientific discipline (Mirakhor, 2007). Abbas Mirakhor, by considering philosophical reasoning, and the historicity of Islam in developing economic postulates, he can be considered as an Islamic economic realist who appeared to purify economic realism.

7. Conclusion

Abbas Mirakhor in the spectrum of Islamic economic thought is grouped as the initiator of the New Institutional Islamic Economics—an idea based on a philosophical view in which to develop and encourage the realization of an ideal Islamic economy. Following this, an institution is needed, both in terms of the Islamic value system and archetype models that were formulated from Islamic meta-framework. This is the foundation of the argument of the current study that, NIE (New Institutional Economics) applied by Abbas Mirakhor is inseparable from his intellectual interaction with the NIE tradition in conventional economics. This also encourages Abbas Mirakhor to introduce the structure of the methodology of Islamic economics, which is more visible as "New Realism Islamic Economics". This is indicated by the number of approaches used by Abbas Mirakhor in developing and producing Islamic economic theories.

In practice, Abbas Mirakhor produced Islamic economic theories through reading; hermeneutic interpretation of the source of Islamic meta-framework—the Quran; Sunnah and *Turats*. This hermeneutic approach serves as an instrument in building and formulating postulates of Islamic economic theory, which functions in research as a theoretical evaluation principle for economic experience that can be observed empirically. This kind of methodology certainly needs development and institutionalization. In order to construct Islamic economic methodology, it does not appear to be mere replication of positivism, and becomes a distinction that can distinguish processes, mechanism and procedure of Islamic economic research.

References

Al-Daghistani, S. (2017). *The making of Islamic economics : an epistemological inquiry into Islam's moral economic teachings, legal discourse, and Islamization process*. Dissertation : Leiden University.

Al-Sadr, M. B. (1987). *Iqtishaduna*. Bairut: Dar Al-Ta'arif Al-Matbu'ah.

Arafah, M. (2019). Sistem keuangan Islam: Sebuah telaah teoritis. *Al-Kharaj: Journal of Islamic Economic and Business*, *1*(1), 1–8.

Arrow, K. (2016). *What is neoclassical economics ?* (Jamie Morgan (ed.)). Routledge: London.

Askari, H., Iqbal, Z., & Mirakhor, A. (2015). *Introduction to Islamic economics*. New Jersey: Wiley.

Bazerman, C. (2003). Intertextuality: *how texts rely on other texts. In what writing does and how it does it: an introduction to analyzing texts and textual practices.* United States: Erlbaum Publishing.

Brahmachari, D. (2016). Neoclassical economics as a method of scientific research program : a review of existing literature. *MPRA Paper No. 75341*, Munich.

Cattelan, V. (2013). *Islamic finance in Europe: towards a plural financial system*. UK: Edward Elgar.

Chapra, M. U. (1996). *What is Islamic economics?*, Jeddah: IRTI–IDB.

Chapra, M. U. (2000). *The future of economics: an Islamic perspective*. UK: The Islamic Foundation.

Choudhury, M. A. (2018). Micro-money, finance and real economy interrelationship in the framework of Islamic ontology of unity of knowledge and the world-system of social economy. *International Journal of Social Economics*, *45*(2), 445-462.

Haneef, M. A., & Furqani, H. (2011). Methodology of Islamic economics: Overview of present state and future direction. *International Journal of Economics, Management and Accounting*, *19*(1), 1–26.

Harmen, R. (2011). *Analisis peran IMF (International Monetery Fund) dalam privatisasi BUMN di Indonesia: Studi kasus privatiasi PT . Indosat , Tbk 1431 H / 2011 M*. Jakarta: Universitas Islam Negeri Syarif Hidayatullah.

Huemer, M. (2002). *Epistemology: contemporary reading*. London: Routledge.

Hutchison, T. W. (1938). *The Significance and basic postulates of economic theory*. UK: MacMillan.

Khan, M. A. (1994). *An introduction to Islamic economics*. Islamabad: International Institute of Islamic Thought.

Khan, M. A. (2013). *What is wrong with Islamic economics? Analysing the present state and future agenda*. UK: Edward Elgar.

Khori, I., & Yusdani. (2015). *Epistemologi ekonomi Islam*. Yogkarta: Pustaka Satu.
Lawson, T. (2003). Reorienting economics. In *Reorienting economics* (pp. 1–383). London: Routledge.
Machlup, F. (2009). Rejoinder to a reluctant ultra-empiricist. *Southern Economic Journal*, *22*(4), 483–493.
Macknight, V., & Medvecky, F. (2020). Knowing economics. *Social Epistemology*, *00*(00), 1–14.
Mäki, U. (2005). Economic epistemology: hopes and horrors. *Episteme*, *1*(3), 211–222.
Mäki, U. (2009). *The Methodology of positive economics:reflections on the Milton Friedman legacy*. Cambridge: Cambridge University Press.
Mirakhor, A. (2009). Islamic economics and finance : an institutional perspective. *IIUM Journal of Economics and Management*, *17*(1), 31-72.
Mirakhor, A. (2015). *A note on Islamic economics*, *3*(2). Jeddah: IRTI-IDB.
Mirakhor, A., & Askari, H. (2017). *Ideal Islamic economy: an introduction*. UK: Palgrave Mac Millan.
Mirakhor, A., & Krichene, N. (2014). *Introductory mathematics and statistics for Islamic finance*. Singapore: John Wiley & Sons Singapore Pte. Ltd.
Mises, L. Von. (2003). *Epistemological problem of economics*. Alabama: Ludwig von Mises Institute.
Morrison, S. (2019). *The defining characteristics of money in Islamic Law*. *Economix Magazine*, April 5,1-21.
Naqvi, S. N. H. (1981). *Ethics and economics: an Islamic synthesis*. UK: The Islamic Foundation.
Naqvi, S. N. H. (1994). *Islam, economics and society*. London: Kegan Paul International.
Reuten, G. (1996). A revision of the neoclassical economics methodology. *Journal of Economic Methodology*, *3*(1), 39–68.
Rima, S. D. (2003). *Spiritual capital: A moral core for social and economic justice*. Gower: London.
Sagal, P. T. (1977). Epistemology of economics. *Zeitschrift Fiir Allgemeine Wissenschaftstheori*, *VIII*(1), 459–463.
Scheall, S. (2017). What is extreme about Mises's extreme apriorism? *Journal of Economic Methodology*, *24*(3), 226–249.
Shaikh, S. A. (2013). Examining classical and neo-classical theories of development from Islamic perspective and Islamic solutions to contemporary development problems. *The International Journal of Excellence in Islamic Banking and Finance*, *3*(2), 1–15.
Siddiqi, M. N. (1981). *Muslim economic thinking: A survey of contemporary literature*. UK: The Islamic Foundation.
Su'adah, F. (2019). *Intertekstualitas Al-Qur'an: studi gaya hidup pemuda dalam kisah dua pemilik kebun surat al-Kahfi*. Thesis: Pascasarjana Universitas Islam Negeri Sunan Ampel.
Tajuddin, M. S., & Rofie, M. K. (2014). A new paradigm of integration between science and Islam: An epistemological framework. *Journal of Islam and Science*, *1*(1), 1–12.
Zegin, M. (2016). An introduction to intertextuality as a literary theory: definitions, axioms and the originators. *Pamukkale Üniversitesi Sosyal Bilimler Enstitüsü Dergisi*, *25*(1), 299–326.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 101-118
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Identifying Service Quality Priority of Islamic Banks in Malaysia

Suharni Maulan[a*], Siti Nurul Izzati Mohd Hanafi[b], Siti Ngayesah Ab. Hamid[c]

[a,b]*Department of Business Administration, International Islamic University Malaysia*
[c]*Faculty of Economics and Management, National University of Malaysia*

[*]*Corresponding author: suharni@iium.edu.my*

Abstract

Service quality remains a focal issue in banking industry as banking institutions are providing heterogeneous products, including Islamic banks. Particularly when the competition becomes more intense, providing superior service quality provided competitive advantage to the organizations in order to remain relevant in the industry. Accordingly, the purpose of this paper is to identify not only the importance of service quality on customer satisfaction but also to examine the performance of each service quality dimensions in satisfying the customers. Using survey method, data of 413 respondents have been analysed using PLS-SEM. The study used PARKSEV model which is enhanced with "compliance" dimension to measure service quality as it is developed in a non-Western cultural context which better suits Malaysia environment. The result shows that the service quality dimensions that contribute significantly to customer satisfaction are "reliability", "sincerity", "compliance", "convenience" and "responsiveness". In terms of performance, "compliance" and "sincerity" are well executed as they are classified in the first quadrant. However, another two dimensions which are "convenience" and "responsiveness" fell in the fourth quadrant which should be taken corrective actions as both dimensions are important but do not performing well. "Reliability" is nearing the third quadrant indicating that though it is significant, but the dimension is relatively less critical as it has been appropriately delivered. Using the Importance-Performance Matrix Analysis (IPMA), the findings provide insights to Islamic bank managers on resource allocation priority and further investment in technology to enhance service quality performance.

Keywords: Customer satisfaction, IPMA, Islamic banks, PAKSERV, Service quality

1. Introduction

The Islamic banking sector worldwide has witnessed remarkable expansion over the past several years (Mahdzan et al., 2017). This is shown by the industry steady growth in terms of size and geography (Khamis and AbRashid, 2018), and also stable and resilient performance during the last financial crisis, which is better than the capitalist financial system (Smolo and Mirakhor, 2010). The growth and good performance is influenced among others by the ability of the bank to attract participation not only from the Muslim group, but also from the non-Muslim consumers (Khamis and AbRashid, 2018). However, in the context of Malaysia, the banks operate in a 'dual-banking system' in which Islamic and conventional banks are operating side-by-side. For the Islamic banking industry alone, there are a total of sixteen players of which six are foreign (Bank Negara Malaysia, 2020). Apart from two Islamic banking institutions from the Middle East, another three are locally incorporated foreign banks that have established their full-fledged Islamic subsidiaries. Being multinationals, these banks further add to the stiff rivalry hence surviving in a competition to attract both groups of consumers is not an easy task. Therefore, improvement of service quality is important as it would enhance customer satisfaction (Cronin and Taylor, 1992) and retain bank's competitiveness and attractiveness (Shariff, 2013).

Article history:
Received 13 July 2020
Revised 16 September 2020
Revised 6 October 2020
Accepted 18 October 2020

Indeed various studies have been conducted related to the service quality of Islamic banks. However, most of the studies conducted used measurement scales developed in the Western context such as SERVQUAL which have been questions on its applicability to suit different country situations (Famiyeh et al., 2018; Haron et al., 2020). Consequently, this has caused inconsistent findings (Famiyeh et al., 2018) and led to unsatisfactory and unsuitable marketing strategies (Laroche et al., 2004). In order to overcome this problem, Raajpoot (2004) has developed a non-Western cultural context model called PAKSERV, which based on the argument that service quality and customer satisfaction is a cultural phenomenon (Malhotra et al., 2005). However, despite the proof that PAKSERV is an appropriate scale in considering culture, customers' religious affiliation is absent. Therefore, in fulfilling this gap, first, this study aims to employ this cultural approach with the consideration of 'compliance' dimension (Othman and Owen, 2001) in examining the service quality of Malaysian Islamic banks.

Secondly, most studies on service quality do not present the importance-performance measure in their research. In the early service recipient satisfaction assessment models, past studies provide basic information about the importance or accumulated dimensions' attribution on satisfaction without pointing out its real performance. However, measuring existing performance to develop an appropriate strategy for achieving the optimal level is a key element in quality assurance (Fathi et al., 2011). As such, Importance-Performance Matrix Analysis (IPMA) is utilised as it is an efficient tool for prioritizing service indicators, enhancing service quality and for addressing customer satisfaction as well as concentrate resources to achieve improved performance (Khalifeh and Razavi, 2012). These outcomes give beneficial information so that researcher could suggest appropriate opportunities for improving Islamic bank services.

Accordingly, the remaining part of this article is organised as follows: First, literature related to service quality is presented. Then, the hypotheses development and research methodology are explained, followed by data analysis and result of the study. Finally, the article is closed with discussion and conclusion, limitations of the study also suggestion for future studies.

2. Literature review

2.1 Service Quality

Service quality is usually defined from the perspective of end users. For example, according to Grönroos (1984), service quality refers to "a perceived judgment, resulting from an evaluation process where customers compare their expectation with the service they have received". In the same view, Parasuraman et al. (1985) defined service quality as "the difference between expectations and performance of the service", which could be interpreted as the gap between customers' expectation, and their perception upon receiving the service. In other words, service quality is the function of pre-purchase customer expectations, perceived process quality, and perceived output quality.

On the other hand, from the Islamic perspective, quality or in Arabic language '*itqan*' refers to the act of arranging or disposing things in an artistic manner in order to obtain the perfect result or high quality (Shariff, 2013). Al-Thabrani reported that Prophet Muhammad (peace be upon him) said "*Allah* loves to see one's job done at the level of *itqan*" (Al-Dimasqi, 2006). As such, an effort to do so is essential and particularly relevance with Islamic principle as the goal to attain perfection is regarded to be a form of duty towards the society (Al-Zaabi, 2006) and also considered to be a type of worship (Shariff, 2013). In the context of Islamic bank, as the bank operation and principles is according to the Islamic law (Shariah), products and services offered by the bank as such is expected to be of high quality.

In order to measure the perceived service quality of an organisation, it is important to use an appropriate tool. To date, there are several existing service quality models, such as the disconfirmation of expectations model by Oliver (1977), the Nordic model by Grönroos (1984), the SERVPERF model by Cronin and Taylor (1992), the three components model by Rust and Oliver (1994) and the integrated model by Brady and Cronin (2001). However, the most popular measurement model used in various empirical studies is SERVQUAL created by Parasuraman et al. (1988). Despite its popularity, over the last ten years, scholars have questioned the applicability of SERVQUAL to suit different country context (Amin and Isa, 2008; Famiyeh et al., 2018). Not only that, other service quality model developed in individualistic cultural settings also have been criticised as it could not be replicated in a collectivist cultural context (Strandberg et al., 2012). As such, a culturally specific service quality scale is needed to correctly and comprehensively report the state of service quality (Prakash and Mohanty, 2013).

In the effort to fill this void, Othman and Owen (2001) introduced alternative measure for service quality by developing a model called the CARTER model, which is well-known in the Islamic banking studies. This model has been implemented in many subsequent studies on the Islamic bank of different countries (Shafie et al., 2004; Tahir and Bakar, 2007). However, CARTER model is based on SERVQUAL with an additional dimension called 'Compliance', which is still not culturally specific.

In the context of Malaysia, an analysis using Hoftstede's dimension reveals a huge difference between the Malaysian culture and the Western paradigm. For example, one of the Hoftstede's dimensions known as the 'power distance' states that each individual in a society is not equal. It expresses the cultural attitude towards inequalities among us. Malaysia scores very high on this dimension (score of 100); which indicates that people accept a hierarchical order in an organisation which is different with Western culture. On the other hand, Malaysia scores 36 on the dimension of 'uncertainty avoidance' and thus has a low preference for avoiding uncertainty which means that the Malaysian society maintains a more relaxed attitude where practice counts more than principles, and deviance from the norm is more easily tolerated.

These differences between Asian and Western cultures or specifically how Malaysia differs from the West indicated the need to find and use a culturally sensitive service quality measurement. Therefore, scholars proposed to complement new dimensions that can increase the comprehensiveness of service quality measurements (Choudhury, 2013). Furthermore, in the context of bank, extensive competition in today's world forces banks to struggle to sustain market share where aspects like obtaining context-specific information and culturally sensitive scales are imperative to provide practical solutions for respective service organisations (Ganguli and Roy, 2011).

Thus, in this light, Raajpoot (2004) developed a cultural context model named as PAKSERV to best suit the collectivist culture of Pakistan. Considering its applicability, scholars have called for other researchers to test the model in different country and culture (Ladhari, 2008). Haron et al. (2020) also found that PARKSERV scale fit Malaysian Islamic banking industry very well. Nevertheless, for this study, the 'compliance' dimension is added as past literature show that compliance is significant in measuring the Islamic bank's service quality and it is in line with cross-cultural and religious differences between two key customer segments, Muslims and non-Muslims (Amin and Isa, 2008). As such, it is imperative to add this dimension into the PAKSERV model as in Malaysia, forty percent of Muslims were motivated to use product and service of Islamic banks due to the 'compliance' factor (Haron et al., 1994).

2.2 Customer Satisfaction

Over the past decade, most research on service quality pays particular attention on its ability in creating customer satisfaction. This is because, customer satisfaction is said to be a key aspect for organisations that wish to develop and maintain their competitive advantage (Fonseca, 2009). Not only that, meeting customers' need and satisfaction also has been said to be the key of business survival (Khamis and AbRashid, 2018) and the reason of customer's loyalty (Janahi and Al Mubarak, 2017).

Customer satisfaction according to Fonseca (2009) is defined as "an overall assessment of the performance of various attributes that constitute a service". In order to understand satisfaction, it is important to understand the factors or attributes that lead to greater customer satisfaction (Sayani, 2015). In relation to this, various studies have constantly repeated the role of service quality in determining customers' satisfaction (Kassim and Bojei, 2002). This relationship is underpin by the social exchange theory which stated that "voluntary actions of individuals are motivated by the return they are expected to bring from others" (Blau, 1964). Thus, customers' satisfaction is motivated by the quality of service provided by the bank. In the context of this study, the explanation of proposed hypotheses below point out the role that might be possessed by each service quality dimensions in influencing customer's satisfaction.

3. **Hypotheses Development**

3.1 Reliability

Parasuraman et al. (1985) defined reliability as an organisation's ability to maintain the consistency of their performance and dependability. In the same view, Raajpoot (2004) conceptualised reliability as the ability to perform the promised service dependably and accurately, which dependability refers to fulfilling promises including time commitment, while accuracy refers to making a minimum number of mistakes (Dahari et al., 2015; Islam et al., 2015; Kashif et al., 2016).

Recent studies show that reliability is one of service quality dimensions which significantly contribute towards customer satisfaction (Famiyeh et al., 2018; Haron et al., 2020; Kashif et al., 2016; Narteh, 2018). On the other hand, Dahari et al. (2015) included reliability and found that it is the least important dimension considered by banks' patrons in Jakarta, Indonesia. In contrary however, studies on the Malaysian Islamic bank conducted by Kashif et al. (2015) revealed that the hypothesised relationship between reliability and customer satisfaction was not supported. Despite this contradictory finding, since most studies have found positive and significant relationship between reliability and customer satisfaction, therefore, this study hypothesised that:

H1. Reliability positively influences customer satisfaction towards Islamic banks.

3.2 Tangibility

Tangibility is one of the SERVQUAL's dimensions stated in Parasuraman et al. (1985). Tangibility includes the physical evidence of the service such as physical facilities, the appearance of personnel, tools or equipment used to provide the service and physical representations of the services such as plastic credit card or a bank statement (Dahari et al., 2015; Islam et al., 2015; Kashif et al., 2016; Parasuraman et al., 1985; Raajpoot, 2004).

Various studies have been conducted on the relationship between tangibility and customer satisfaction. For example, Rehman (2012) performed a comparative study on the relationship between tangibility and customer satisfaction in Pakistan, the United Kingdom (UK) and the United Arab Emirates (UAE). Result of the study showed that tangibility significantly affects satisfaction in Pakistan and UAE, but was insignificant in the UK. This insignificant relation is supported by Khamis and AbRashid (2018) which reflects a similar finding in his study. However, in contrary, a positive and significant relationship between tangibility and satisfaction was found in the context of Malaysian Islamic bank (Haron et al, 2020; Kashif et al., 2015) This is also supported by Dahari et al. (2015), Kashif et al. (2016), and Narteh (2018) which found similar results. Thus, the study hypothesises:

H2. Tangibility positively influences customer satisfaction towards Islamic banks.

3.3 Assurance

Raajpoot (2004) has also included assurance, which is adapted from SERVQUAL as one of the PAKSERV service quality dimensions. Assurance refers to employee's knowledge, courtesy, and ability to convey trust and confidence (Berry et al., 1998). The relationship between assurance and customer satisfaction has been tested in several studies. For example, Ebrahimi and Moghadam (2012) conducted a survey to recognise the most important dimensions of the service quality in Iran's commercial banks. The outcome of this study clearly stated that assurance is the most important dimension in determining service quality among Iran's commercial banks' customers. The results proven that the employees' courtesy and confidence are valued by customers the most. This finding is similar with Haron et al. (2020) who found that assurance is the most important dimension for service quality for Malaysia Islamic banks. However, Narteh (2018) and Kashif et al. (2016) indicates that even though assurance significantly contributes towards customer satisfaction, it is the least important dimension. On the contrary, other recent studies are unable to find a significant relationship between assurance and customer satisfaction (Famiyeh et al., 2018; Khamis and AbRashid, 2018). In view of these, in the context of this study, it is hypothesised that:

H3. Assurance positively influences customer satisfaction towards Islamic banks.

3.4 Sincerity

Specifically, Raajpoot (2004) defined sincerity as consumer's evaluation of the genuineness of service personnel. Kashif et al. (2016) had simplified the definition by saying that, sincerity is the attitude of personnel for being genuine and original while providing the service. In the context of Islamic bank, sincerity could be portrayed by having bank personnel who are knowledgeable and always ready in providing solutions and answers concerning Islamic banking products and services (Hamzah et al., 2015). Few studies have been conducted on the effects of sincerity towards customer satisfaction. Among others, Grönroos (2000) acknowledged that employee's sincerity and personal knowledge about customers is a key to satisfaction. In addition, Kashif et al. (2016) applied PAKSERV model in Pakistan and Haron et al. (2020) in Malaysia where both studies found that sincerity significantly contributes towards customer satisfaction. This leads the study to hypothesise:

H4. Sincerity positively influences customer satisfaction towards Islamic banks.

3.5 Personalisation

Personalisation refers to customisation and individualised attention, and to some extents, it is addressed in the empathy dimension of SERVQUAL (Raajpoot, 2004). Karami et al. (2016) asserted that personalisation involves how customers measure service company employees on their aptitude to recognise customers' place in society and the importance they hold for the service provider. Personalisation is important in measuring service quality in Eastern context due to the fact that Asians scored high on power distance which translates as the customers' desire for individual identity despite being parts of a group (Winsted, 1997). Although Asian is known as a collectivist people, one's need to be recognised or individually treated is still important as each individual is still open to maintaining the status quo, hence, public recognition of one's social status is very important in societies with high power distance (Hofstede, 1980). Based on this, a personalisation strategy could be used by Islamic banks to attract customers. In this light, offering highly customised solutions to customers have been found to help marketers to attract more customers (Imrie, 2013). Interestingly, Haron et al. (2020) found that in Malaysia, personalisation is the second most critical dimension of service quality after assurance. Therefore, it is hypothesised that:

H5. Personalisation positively influences customer satisfaction towards Islamic banks.

3.6 Formality

Formality is largely being discussed in terms of social distance, role deference, forms of address, and ritual (Raajpoot, 2004). Specifically, formality is defined as consumer's evaluation of how well social distance is being maintained and cultural rituals are being performed (Kashif et al., 2015; Kashif et al., 2016). Karami et al. (2016) proposed that, formality denotes how customers evaluate service company employees' aptitude to uphold their social distance by demonstrating decorous behaviour, acknowledging families and showing total courtesy to customers. Among others, dressing appropriately, addressing customers by their family names, being attentive, and restricting conversation to a minimum, are some of the behaviours that depict formality (Winsted, 1997).

Result on the significance of formality in influencing customers' satisfaction has been mixed. Raajpoot (2004) provides empirical evidence that formality was the most significant factor in the Pakistan context. However, study by Haron et al. (2020) and Kashif et al. (2016) for example show that although the "formality" dimension was significant, it is the least important compared to the other dimensions. This is similar to Saunders (2008) who replicated the PAKSERV model in the African banking context and found that formality was a less desirable service quality dimension. In this light, it is imperative to conduct a current study on this aspect from time to time. Hence, this study hypothesises:

H6. Formality positively influences customer satisfaction towards Islamic banks.

3.7 Compliance

Compliance, as defined by Othman and Owen (2001) refers to the ability of the bank to adhere to the Islamic or Shariah law and operate under the principles of Islamic banking and economy. Among others, bank is expected to comply to the Shariah rule that prohibits *riba* (usury), *gharar* (uncertainty) and *maisir* (gambling), also forbid involvement with other businesses considered unlawful or *haram* such as brewery and casino (Badara et al., 2013).

Studies show that fear of divine punishment is the second most significant determinant of one's attitude on Islamic banking. Several researches have shown the relationship between fears (in general) and attitude (Eadie et al., 2009; Johnston and Warkentin, 2010), in which maintaining the 'fear' has a considerable effect on individuals and their attitudes toward certain situations or certain objects. Thus, the more a person is afraid of doing something *haram,* the more favourable their attitude would be towards Islamic banking. This is proven by (Rehman, 2012) which found that compliance is the most important factor for selecting Islamic bank in the context of Pakistan, UK and the UAE. However, similar to Badara et al. (2013), Rehman (2012) could not found a significant relationship between compliance and customer satisfaction in the three countries. Despite this, Shariff (2013) stated that religious beliefs play an assertive role to induce customers to use Islamic bank. Similarly, Khamis and AbRashid. (2018) and Dahari et al. (2015) revealed that Shariah compliance is an important dimension in evaluating an Islamic bank service quality. Therefore, based on these arguments, it is hypothesised that:

H7. Compliance positively influences customer satisfaction towards Islamic banks.

3.8 Responsiveness

Responsiveness describes the desire, willingness and readiness of service providers to assist customers and to deliver prompt service (Abdullah et al., 2011). Responsiveness is a critical factor in the evaluation of service quality, and as such bank should ensure that their personnel are responsive in all dealings with customers (Abdullah et al., 2011). In retail banking, Ravichandran et al. (2010) and Ladhari et al. (2011) have found a significant role played by responsiveness in predicting customer satisfaction. The same result was also revealed by Ravichandran et al. (2010) who used SERVQUAL scale to study service quality in India and found that responsiveness was the only significant factor in predicting customer satisfaction. However, some other studies found a contradictory result that does not support the relationship between responsiveness and satisfaction. Thus, in order to investigate the nature of relationship between responsiveness and satisfaction in the context of Islamic bank in Malaysia, it is hypothesised that:

H8. Responsiveness positively influences customer satisfaction towards Islamic banks.

3.9 Convenience

Kumar et al. (2009) and Taap et al. (2011) found that convenient banking facilities contribute towards customer satisfaction. Thus, convenience dimension is also included in this study. According to Berry et al. (2002), the perceptions of service convenience affects customers' evaluation of the service and the perceived service quality. Kumar et al. (2009) found that the convenience factor plays a substantial role in the delivery of bank service quality in Malaysia. Studies also found that bank users always look for convenience when performing banking transactions (Dhar and Kushwah, 2009). Based on the empirical results, customers expect banks to provide a variety of channels to enhance service convenience, which encourages repeat patronisation (Moghavvemi et al., 2018).

Previous study was conducted by comparing the convenience variable between conventional and Islamic banks in Malaysia found that conventional bank should improve their services towards elderly, pregnant ladies and disabled customers, while Islamic bank should provide more ATMs facilities to ease banking transaction (Taap et al., 2011). The same assumption applied to the banking industry in Pakistan, where researchers proved that convenience was ranked as a third important contribution in determining the overall service quality after customer focus and employee service variables (Muhammad Awan et al., 2011). Though convenience is a known contributing factor, it is still tested in this study as convenience is based on customers' terms and not the terms of the bank. Hence, the following hypothesis is proposed:

H9. Convenience positively influences customer satisfaction towards Islamic banks.

4. Methodology

4.1 Measurement and Scaling

A quantitative study was conducted to investigate the role played by service quality dimensions in determining customer satisfaction. A structured questionnaire was designed to obtain response from the targeted respondents. The first part of the questionnaire consists of general questions related to the respondents' relationship with Islamic bank. The second part of the questionnaire covers items related to the service quality dimensions and customer satisfaction. Lastly, the questionnaire ended with section on the respondents' demographic profile such as gender, age and educational level. Specifically, the items measuring service quality were adapted from Rajpoot (2004) and Othman and Owen (2001) while items related to customer satisfaction were adapted from Amin and Isa (2008). A six-points Likert-type scale was used as it gives higher reliability than the five-points Likert's scale (Chomeya, 2010).

4.2 Sampling

The questionnaire was administered within Islamic banking customers. Three criterions were used to ensure the eligibility of the respondents. First, the selected respondents must be adult, as they have the capacity to make their own wise decision on their preferred banks (Dusuki and Abdullah, 2007; Osman, 2011). Second, the respondents should have used the bank services for at least six months as it is considered an adequate duration for consumers to make evaluation pertaining to his or her experiences with the bank (Dagger et al., 2009). Finally, the respondents need to live or work within the Kuala Lumpur and Selangor area as these areas have more Islamic banks branches compared with other states in Malaysia (Maulan et al., 2016). The questionnaires were distributed in offices around these areas as it is considered as one of the common public places where respondents can be easily accessed as compared to other places such as a home (Cooper and Schindler, 2014; Maulan et al., 2016). In total, 450 questionnaires were distributed but only 424 questionnaires were returned. After the questionnaires were filtered, 413 questionnaires were valid for further analysis resulting to an adjusted response rate of 91.78 per cent. Table 1.1 shows the detail breakdown of the demographic profile.

Table 1.1: Respondents' Profile

Demographic Profile		Frequency (n=413)	Percentage
Gender	Male	155	37.5
	Female	258	62.5
Age	18 to 25 years	107	25.9
	26 to 35 years	159	38.5
	36 to 45 years	85	20.6
	46 to 55 years	48	11.6
	56 years and above	14	3.4
Religion	Islam	357	86.4
	Buddhist	25	6.1
	Hindu	13	3.1
	Christian	17	4.1
	Others	1	0.2
Education	SPM and below	46	11.1
	Diploma/Matriculation/A-Level	68	16.5
	Bachelor degree	199	48.2
	Master	65	15.7
	PhD	31	7.5
	Others	4	1.0
Monthly Income	Less than RM 2000	101	24.5
	RM 2,001 - RM 4,000	120	29.1
	RM 4,001 - RM 6,000	78	18.9
	RM 6,001 - RM 8,000	38	9.2
	RM 8,001 – RM 10,000	18	4.4
	More than RM 10,001	25	6.1
	No Income	33	8.0
Bank Accounts	Islamic banking only	135	32.7
	Islamic banking and conventional banking	278	67.3
Length	6 months to 2 years	86	20.8
	2.1 to 5 years	96	23.2
	5.1 to 10 years	112	27.1
	10.1 years and above	119	28.8
Services/ product used	Saving Account	377	91.3
	Current Account	103	24.9
	Investment Account	38	9.2
	Vehicle Financing	90	21.8
	Home Financing	72	17.4
	Personal Financing	44	10.7
	Credit Card/Charge Card	53	12.8
	Others	4	1.0

5. Data Analysis and Findings

Partial Least Square Structural Equation Modelling (PLS-SEM) analysis was used to analyse the data. Primarily, PLS-SEM consists of a two-step approach. At the first step, a comprehensive valuation of the measurement model at the item level was conducted, followed by a higher order level analysis of the posited structural relationships. The process involves separate assessments which are known as measurement models and the structural model (Hair et al., 2014).

5.1 Measurement Model

At the first stage, an analysis on the measurement model was performed which focused on the reliability and validity of the construct measures (Hair et al., 2014). Table 1.2 shows result of the convergent validity where all value of alphas (CA) and composite reliability (CR) exceed the recommended threshold value of 0.7 indicating that all the constructs have high level of internal consistency reliability (Hair et al., 2010). In addition, the outer loadings and the average variance extracted (AVE) were also examined. Upon investigation, two items were deleted (Conv7 and Per1) as the loadings for both items are lower than 0.7. The remaining outer loadings were higher than the cut off value 0.708 (Hair et al., 2014) indicating that all constructs have high levels of internal consistency reliability. Besides that, the result shows that that the AVE values surpass 0.60 which is above the required minimum level of 0.50.

Table 1.2: Reliability and Convergent Validity

Construct	Item	Loadings	AVE	CR	CA
Reliability	Rea1	0.794	0.650	0.917	0.892
	Rea2	0.879			
	Rea3	0.774			
	Rea4	0.810			
	Rea5	0.811			
	Rea6	0.764			
Tangibility	Tan1	0.818	0.689	0.930	0.909
	Tan2	0.851			
	Tan3	0.769			
	Tan4	0.808			
	Tan5	0.880			
	Tan6	0.850			
Assurance	Ass1	0.793	0.664	0.922	0.899
	Ass2	0.782			
	Ass3	0.782			
	Ass4	0.830			
	Ass5	0.859			
	Ass6	0.839			
Sincerity	Sin1	0.885	0.777	0.946	0.928
	Sin2	0.883			
	Sin3	0.888			
	Sin4	0.862			
	Sin5	0.888			
Formality	For1	0.785	0.642	0.899	0.860
	For2	0.856			
	For3	0.868			
	For4	0.702			
	For5	0.784			
Personalization	Per2	0.864	0.770	0.944	0.925
	Per3	0.882			
	Per4	0.867			
	Per5	0.892			
	Per6	0.883			

Compliance	Com1	0.800	0.665	0.908	0.874
	Com2	0.820			
	Com3	0.824			
	Com4	0.830			
	Com5	0.802			
Responsiveness	Resp1	0.794	0.749	0.937	0916
	Resp2	0.879			
	Resp3	0.774			
	Resp4	0.810			
	Resp5	0.811			
	Resp6	0.764			
Convenience	Conv1	0.707	0.600	0.899	0.866
	Conv2	0.747			
	Conv3	0.849			
	Conv4	0.766			
	Conv5	0.776			
	Conv6	0.793			
Customer Satisfaction	Cus1	0.916	0.839	0.954	0.936
	Cus2	0.919			
	Cus3	0.901			
	Cus4	0.927			

Then, in order to ensure that the constructs are distinct between one and another, a discriminant validity assessment was conducted. Table 1.3 shows the results of the Fornell-Larcker criterion assessment. Overall, the square roots of the reflective constructs AVE are higher than the correlations of these constructs with other latent variables in the path model (Hair et al., 2014) indicating that the discriminant validity was established for the study constructs.

Table 1.3: Discriminant Validity (Fornell-Larcker Criterion)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Reliability (1)	0.806									
Tangibility (2)	0.680	0.830								
Assurance (3)	0.719	0.755	0.815							
Sincerity (4)	0.683	0.681	0.778	0.881						
Personalization (5)	0.624	0.605	0.674	0.777	0.878					
Formality (6)	0.623	0.674	0.745	0.808	0.762	0.801				
Compliance (7)	0.556	0.533	0.599	0.625	0.591	0.584	0.815			
Responsiveness (8)	0.609	0.614	0.692	0.763	0.824	0.759	0.611	0.866		
Convenience (9)	0.488	0.547	0.556	0.552	0.581	0.566	0.558	0.631	0.774	
Satisfaction (10)	0.641	0.623	0.677	0.751	0.737	0.698	0.665	0.777	0.636	0.916

Note: diagonal represents the square root of the AVE and the off-diagonal represent the correlations

However, the ability of Fornell and Larcker's criterion in assessing discriminant validity reliably has been criticised (Henseler et al., 2015). As such, the HTMT ratio of correlations has been proposed as a better measurement of discriminant validity. Table 1.4 shows the result of discriminant validity assessment using HTMT developed by Henseler et al. (2015). All the values stated are lower than the required threshold of HTMT of 0.90 (Gold et al., 2001), indicating that discriminant validity is established for the studied constructs.

Table 1.4: Discriminant Validity (HTMT)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Reliability (1)										
Tangibility (2)	0.756									
Assurance (3)	0.808	0.834								
Sincerity (4)	0.749	0.740	0.730							
Personalisation (5)	0.685	0.659	0.732	0.838						
Formality (6)	0.707	0.758	0.842	0.895	0.846					
Compliance (7)	0.630	0.597	0.673	0.693	0.656	0.676				
Responsiveness (8)	0.668	0.671	0.750	0.825	0.894	0.846	0.682			
Convenience (9)	0.550	0.611	0.624	0.610	0.642	0.649	0.634	0.701		
Satisfaction (10)	0.700	0.673	0.730	0.806	0.791	0.768	0.734	0.837	0.701	

5.2 Structural Model

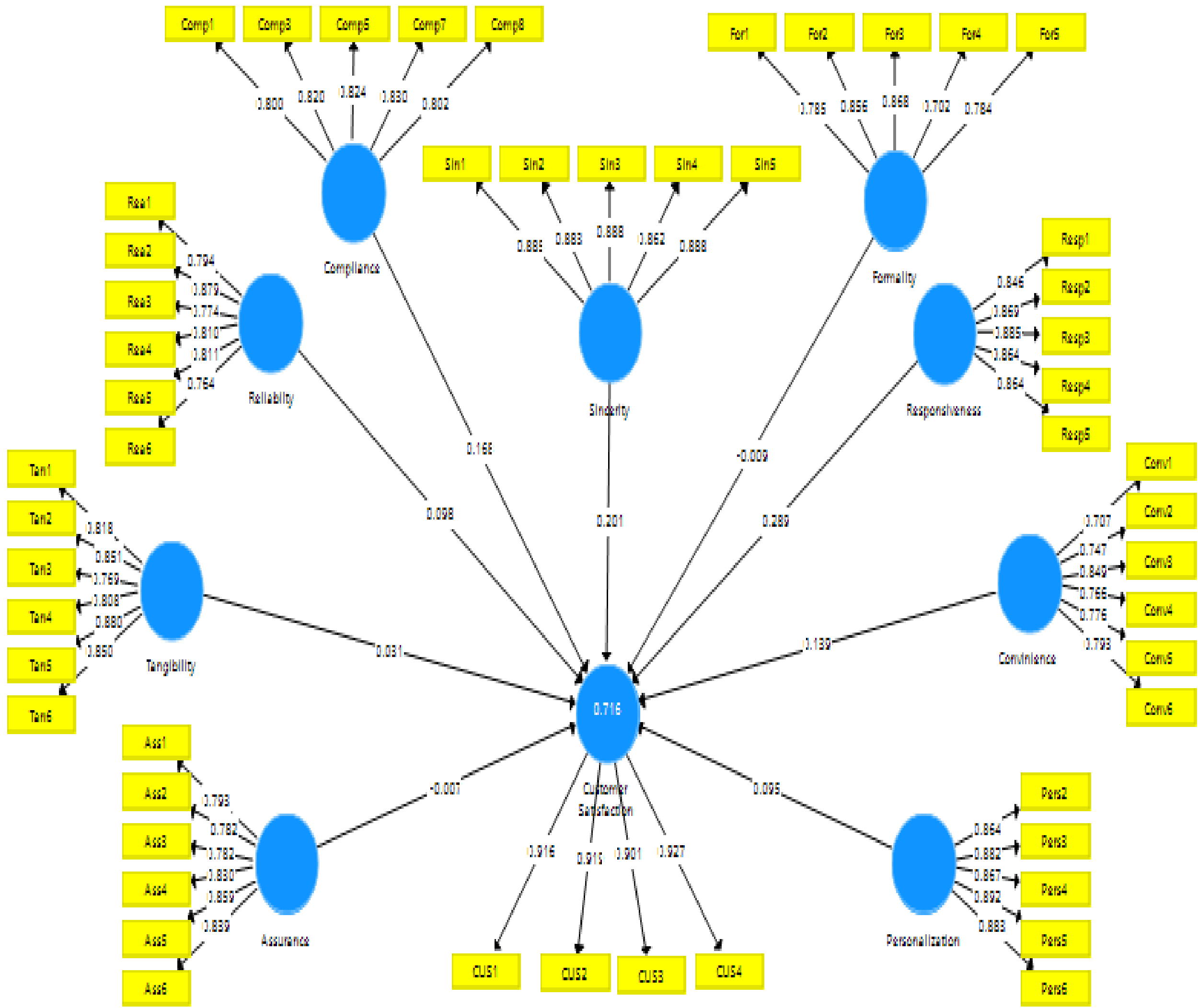
The structural or inner model represents the relationship between constructs or latent variable as hypothesised in the research model (Hair et al., 2014). First, collinearity assessment was conducted and the result shows that all the VIF values are below the threshold of 5 (Hair et al., 2017) indicating that collinearity among the predictor constructs is not an issue. Then, the structural path of the model was examined. Table 1.5 describes the summarised results of the proposed structural model. Critical values for a two-tailed test are 1.65 (significance level=10%), 1.96 (significance level=5%) and 2.57 (significance level=1%) (Hair et al., 2014). However, in application, researchers should consider path coefficients with a 5% or less probability error as significant (Hair et al. 2014). Based on this, the results show that five service quality dimensions are significant in determining customer satisfaction towards Malaysian Islamic banks. Among the five significant dimensions, responsiveness demonstrates the largest path coefficient (β =0.289, $p<0.01$), followed by sincerity (β =0.201, $p<0.01$), compliance (β =0.168, $p<0.01$), convenience (β= 0.139, $p<0.05$) and reliability (β =0.112, $p<0.05$). Finally, as shown in Figure 1, the R^2 value for customer satisfaction is 0.716 where following the rules of thumb, the R^2 value is considered as substantial (Hair et al., 2014).

Table 1.5: Hypotheses Testing Results

Hypothesis	Path Coefficient.	t- statistics	p-values	Decision
H1: Reliability → customer satisfaction	0.112	2.121**	0.034	Supported
H2: Tangibility → customer satisfaction	0.031	0.482 (n.s)	0.630	Not supported
H3: Assurance → customer satisfaction	-0.007	0.104 (n.s)	0.917	Not supported
H4: Sincerity → customer satisfaction	0.201	3.216***	0.001	Supported
H5: Formality → customer satisfaction	-0.009	0.167 (n.s)	0.867	Not supported
H6: Personalization → customer satisfaction	0.095	1.511 (n.s)	0.131	Not supported
H7: Compliance → customer satisfaction	0.168	2.933***	0.003	Supported
H8: Convenience → customer satisfaction	0.139	2.466**	0.014	Supported
H9: Responsiveness → customer satisfaction	0.289	3.913***	0.000	Supported

Note: *** $p < 0.01$,** $p < 0.05$, n.s. not significant

Figure 1: PLS Generated Result: Coefficient of Determination (R^2)



5.3 Importance-Performance Matrix Analysis (IPMA)

Importance-performance matrix analysis (IPMA; also known as importance performance map analysis or priority map analysis) is one of the analytical tools in PLS-SEM (eg: Höck et al., 2010). The purpose of using IPMA is to identify relatively low performance attributes with high importance value towards targeted constructs (Ringle and Sarstedt, 2016). In the context of quality, Fathi et al. (2011) mentioned that measuring existing performance to develop an appropriate strategy is a key element in quality assurance. Generally, IPMA provides guidance for the prioritization of important managerial activities underlying the selected target, which require performance improvements.

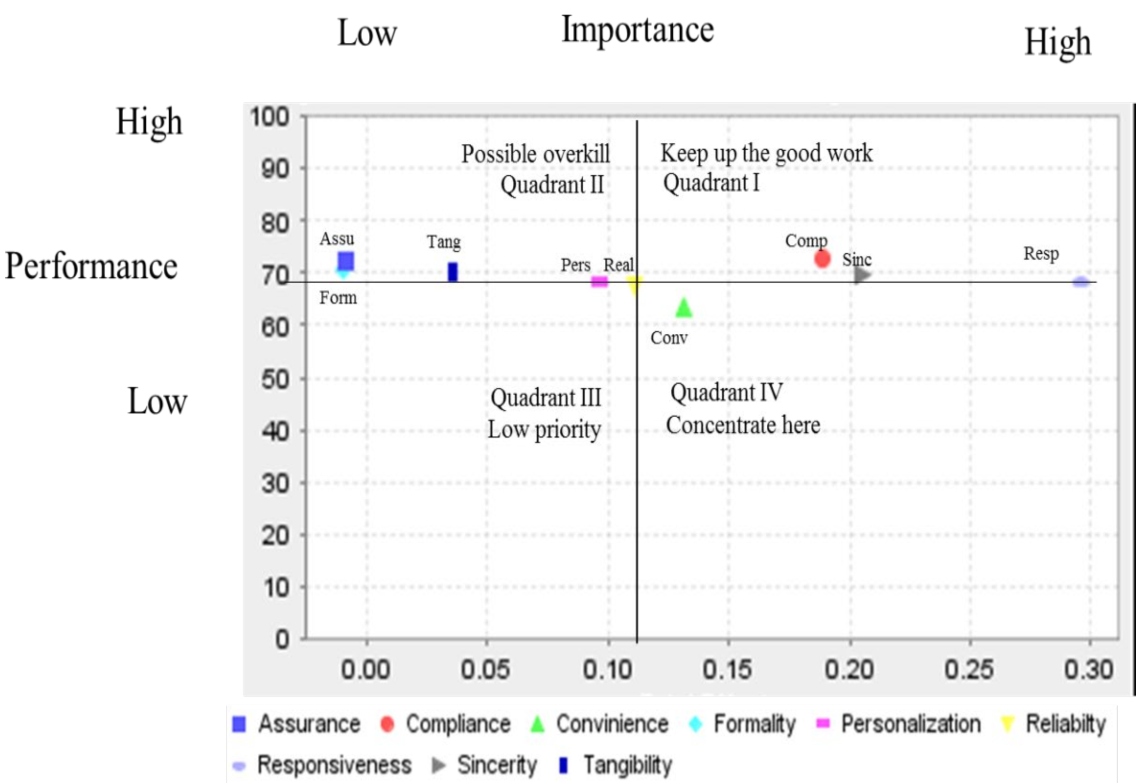
In this study, customer satisfaction is a target construct, which predicted by nine variables namely: reliability, tangibility, assurance, sincerity, personalization, formality, compliance responsiveness and convenience. Table 1.6 provides result of importance-performance values score. It displays that 'responsiveness' has the highest importance score, 0.295. This could be interpreted that an increase by one-unit point in responsiveness quality by the Malaysian Islamic banks will increase the overall customer satisfaction by 0.295 (*ceteris paribus*). However, the performance ranks seventh (68.19) after compliance (72.64), assurance (72.40), formality (70.56), tangibility (69.96), sincerity (65.59) and personalization (68.53).

Table 1.6: Importance, Performance and Mean Value

	Importance	Performances
Responsiveness	0.295	68.19
Sincerity	0.206	69.59
Compliance	0.189	72.64
Convenience	0.131	63.43
Reliability	0.111	67.79
Personalization	0.096	68.53
Tangibility	0.035	69.96
Assurance	0.009	72.40
Formality	0.010	70.56
Mean Value	*0.120*	*69.23*

For a better orientation, Figure 2 shows the mapping of the dimensions into four quadrants with importance and performance values below and above the average (mean value). Figure 2 demonstrates that two significant dimensions: compliance and sincerity are performing well as they are classified in the first quadrant. However, another two dimensions which are convenience and responsiveness fell in the fourth quadrant which should be taken corrective actions as both dimensions are important but do not perform well. On the other hand, assurance, formality and tangibility are classified in the second quadrant or 'possible overkill'. This shows that these factors are less important but have been treated in an utmost significant. Meanwhile, reliability and personalization are nearing the third quadrant known as 'low priority' indicating that both attributes are of less importance and have been treated as they are.

Figure 2: Importance-Performance Map (Construct Level) of Satisfaction



6. Discussion and Conclusion

This study examines nine service quality dimensions to identify their capabilities in enhancing customer satisfaction towards Malaysian Islamic banks. The results show five dimensions have significant relationship with customer satisfaction namely reliability, responsiveness, sincerity, compliance, and convenience. This is in line with the previous studies who have also found a significant relationship between the five variables and customer satisfaction. For example, the relationship between reliability and customer satisfaction has been proven positive and significant in various context before (Janahi and Al Mubarak, 2017; Haron et al. 2020; Kashif et al., 2016; Khamis and AbRashid, 2018). The same goes to responsiveness where Khamis and AbRashid (2018) have also found the same significant result in the context of Islamic bank in Tanzania, while Janahi and Al Mubarak (2017) found it to be significant in influencing customer satisfaction in Bahrain's Islamic bank. On the other hand, similar with other studies that applied PAKSERV model before, sincerity also has been found positive and significant in influencing customer satisfaction (Haron et al., 2020; Karami at al., 2016; Kashif et al., 2016). In addition, in line with Anouze et al. (2019) who found a significant relationship between convenience and satisfaction in the context of Islamic banks in Jordan, this study also found the same, indicating the importance of the distance and time taken by banks in serving customers. Finally, as expected, compliance also has been found positive in influencing customer satisfaction which is similar to the findings of Anouze et al. (2019) and Janahi and Al Mubarah (2017).

In contrary, there are four variables found to be insignificant in influencing customer satisfaction which are tangibility, assurance, personalisation and formality. The insignificant relationship between tangibility and customer satisfaction is inconsistent to some studies such as Haron et al. (2020), Kashif et al. (2015) and Kashif et al. (2016) but in line with Rehman (2012), Badara et al. (2013) and Khamis and AbRashid (2018). This insignificant relationship could be due to several factors among others it is said that the bank physicality such as the building, equipment and employee appearance are expected by customers to be in good condition but their presence does not make the customers more satisfied. However, the failure of the bank to provide the expected basic tangible features could cause negative perception.

Meanwhile, despite past researchers' claim that assurance is an important dimension (Fauzi and Suryani, 2019; Haron et al., 2020; Janahi and Al Mubarak, 2017), this study however found that assurance is not significant in influencing customers' satisfaction towards Islamic bank. This result nevertheless is similar with Shariff (2013) as well as Khamis and AbRashid (2018). In this regard, a conceivable explanation is that majority of the respondents in this study merely held savings and current accounts with Islamic banks. These products are actually basic services offered by Islamic bank which require minimal explanation by bank personnel compared to other complex financial services such as property, auto and personal financing (Mahdzan et al., 2017). In general, customers will interact closely with bank personnel for financial products, which are considered more complicated as opposed to savings or current account. Therefore, respondents in this study may not often have inquiries with the employees.

On personalisation and formality, these two variables can be regarded as new dimensions that have been introduced by Raajpoot (2004). Past studies that applied PAKSERV as their main model for service quality proved both dimensions to be significant in influencing customer satisfaction (Karami et al., 2016; Kashif et al., 2015; Kashif et al., 2016; Raajpoot, 2004; Saunders, 2008).Studies conducted in Malaysia also signify personalisation and formality as contributors to customer satisfaction (Haron et al., 2020; Kashif et al., 2015). Historically, personalization has been added by Raajpoot (2004) in replacing responsiveness. One of the reasons for such result may be due to the existing responsiveness dimension. Customers prefer employees being more responsive rather than the service being personalized individually. Apart from that, due to compliance factor, most customers will abide by all Islamic banking service and product. Even though Malaysia is well known as an Islamic hub globally and majority of the population are Muslims, consumers' knowledge and understanding of Islamic banking is very much lacking (Mahdzan et al., 2017). Most customers seem to put trust towards Islamic banks in handling their financial process as Muslims believe business practices of Islamic banks are part of their worship where all products and services are based on religion (Janahi and Al Mubarak, 2017). Thus, rather than personalizing the service or product by themselves, it is better to follow the advice and recommendations given, as the products are somewhat standardized. The same goes to formality as the customer seems to know their priority in choosing Islamic bank due to its Islamic financial system, thus formality is seen as unimportant compared to other elements.

Despite these findings, interestingly, the IPMA analysis shows that two of the important dimensions, namely convenience and responsiveness, fell in the fourth quadrant or ‘concentrate here’. This indicates that customers regarded such attributes as significant, but were not satisfied with their performance, so this area demands for special attention. Thus, it is vital for the management to provide immediate attention in responsiveness and convenience dimensions in delivering their services so that customer satisfaction could be improved. On the other hand, compliance and sincerity are significant in contributing towards customer satisfaction as they fell in the first or ‘keep up the good work’ quadrant. This indicates that Malaysian Islamic banks have performed well on keeping the high value of sincerity and compliance criteria. As such, the performance of both dimensions need to be maintained and even can be further improved in order to continuously create customer satisfaction. Meanwhile, this study also reveals that few dimensions (assurance, formality and tangibility) are in the second or ‘possible overkill’ quadrant. This provides insights to managers that these dimensions are less important but have been treated more than what is required. As such, resources committed to these attributes could be better used to improve performance of other more important dimensions. As for reliability and personalization which fall in the third or low ‘priority quadrant” indicates that managers of Islamic banks manage these two dimensions effectively.

6.1 Implications

This study offers several implications. Theoretically, this study has integrated several service quality dimensions which come from SERVQUAL, CARTER and PAKSERV models. As the SERVQUAL dimensions measure service quality especially from the Western’s perspective, while CARTER looks into the Islamic elements and PAKSERV contain cultural aspects, this study specifically has developed a new set of service quality dimensions that could test the significance of both religion and cultural aspects in predicting customer satisfaction. In addition, this study also showed that two dimensions from SERVQUAL namely tangibility and assurance, have an insignificant relationship with customer satisfaction, while another SERVQUAL dimension which is reliability was deemed the least important dimension in determining customer satisfaction. This reaffirms Islam et al. (2015) statements on how SERVQUAL dimensions have failed to reach a standard in measuring service quality. Similarly, Prakash and Mohanty (2013) disputed SERVQUAL capability by highlighting the need to employ cultural specific quality scales in reporting service quality. Besides that, the results of this study also have shown that the relationship between religion and culture as compliance is the most significant service quality dimension which influences customer satisfaction. This is followed by other three PAKSERV dimensions sincerity, personalisation and formality. It seems Malaysian Islamic bank customers have reacted towards both factors. Halman and Luijkx (2006) stated that, dominant religion has presumably left a long-lasting imprint on cultures and may shape people’s attitudes even if they are not religious.

Practically, the study findings suggest that Islamic banking practitioners can devise several strategies in creating satisfaction via service quality. First, compliance and sincerity need to be maintained as these two dimensions are the most significant and are performing well. While observing operations to strictly follows the Shariah (Islamic laws) by avoiding elements of *riba (*interest*), gharar (*uncertainty) and *maisir (*gambling*)* is regulatory prerequisite, communicating these aspects via strong brand image need to become a continuous effort. Islamic banks could take proactive action to educate customers by organising more talks sharing on *muamalat* (Islamic transactions), sponsoring relevant television programme or CSR related activities so that the Shariah compliant image could be further enhanced. Whereas, in conveying the characteristics of sincerity, the employees need to show honesty and project a sincere behaviour by having a good knowledge and extending useful advice. Helping customers to have clear understanding and wipe out their worries on the Islamic banking system will lead them to be satisfied on Islamic banks. In order to ensure that employees could interact well with customers, Islamic bank as such is recommended to properly educate and train them, especially on Islamic banking products and services. This step is a ‘double-sword strategy’ where it helps the organisations to improve quality of services and at the same time, to further enhance customer’s awareness and knowledge about the Islamic banking system (Maulan et al., 2016).

On top of that, Islamic bank managers should focus to improve the convenience and responsiveness dimensions as these elements are vital yet underperform. In this digital era, Islamic banks must intensely invest in technologies to transform the way they conduct and distribute banking services (Bernama, 2019). Leveraging on technologies increase responsiveness and provide more convenience to the customers. For example, automated response systems and direct extension options can route calls to appropriate employee faster while technology services channels such as chat box, e-mail and text messages could address service issue more quickly thus improves customer service responsiveness. It is no longer adequate to simply put up a website but in order to thrive in today's environment, Islamic banks need to evolve together with the rapid technological advances. Since more than sixty percent of the respondents are below 35 years old, this provides insights that as more millennials come to the forefront of the society, newer service technologies such as electronic transfer, online banking and mobile apps are becoming more important. The embrace of internet-of-thing, mobile devices, social media integration, big data analytics and artificial intelligences will make banking transactions more automated, user friendly and more convenient, thus giving customers superior service quality delivery.

As for policy makers, Malaysian Islamic banking landscape has been well supported with regulatory, prudential, legal and accounting framework. Initiatives to promote greater education and awareness are also reinforced by numerous education and research institutes. Nevertheless, as Malaysia is practicing a dual banking system, continuous benchmarking exercise within the industries may be put in place. Appreciating the dynamic changes of the industries not only locally but also globally, practitioners and regulators will need to be kept abreast with expectations from all stakeholders. For instance, the national and global recognition and awards will make the presence of the Islamic banks be felt not only locally but also regionally and internationally. This exercise also should shed some light on what is being practiced on other parts of the globe in search of the best way to serve the clients.

6.2 Suggestions for Future Studies

Nevertheless, more research needs to be done in the future. This effort will contribute not only to the academic field, but to the Islamic banking practitioners. This study is conducted in Malaysia, specifically the Klang Valley. Future research may replicate this study in different contexts particularly in *halal* industries where compliance to Shariah is an important dimension. Replicating this study for Islamic banks in different countries may also yield interesting findings. Indeed identifying service quality priority may assist Islamic banks managers to further enhance the performance of Islamic banking industry so that it will sustain for many more years ahead.

References

Abdullah, F., Suhaimi, R., Saban, G., & Hamali, J. (2011). Bank service quality (BSQ) index. *International Journal of Quality & Reliability Management*, *28*(5), 542–555.

Al-Dimasqi, A. M. (2006). *Mawi'zatalmukminin min ihyaUlum al-din li Imam Ghazali. (Transl).* Kuala Lumpur: DarulFajr.

Al-Zaabi, O. S. H. A. (2006). *Quality service in UAE*. Durham University, Durham, UK.

Amin, M., & Isa, Z. (2008). An examination of the relationship between service quality perception and customer satisfaction: a SEM approach towards Malaysian Islamic banking. *International Journal of Islamic and Middle Eastern Finance and Management*, *1*(3), 191–209.

Anouze, A. L. M., Alamro, A. S., & Awwad, A. S. (2019). Customer satisfaction and its measurement in Islamic banking sector: a revisit and update. *Journal of Islamic Marketing*, *10*(2), 565–588.

Badara, M. S., Mat, N. K. M., Mujtaba, A. M., Al-Refai, A. N., Badara, A. M., & Abubakar, F. M. (2013). Direct effect of service quality dimensions on cutomer satisfaction and customer loyalty in Nigerian Islamic bank. *Scientific & Academic Publishing Management*, *3*(1), 6–11.

Bank Negara Malaysia (2020), *List of licensed financial institutions*. Bank Negara Malaysia: Kuala Lumpur.

Bernama. (2019, April 10). PM - Islamic banking players must invest in technologies Retrieved from https://www.nst.com.my/news/nation/2019/04/478016/pm-islamic-banking-players-must-invest-technologies

Berry, L. L., Parasuraman, A., & Zeithaml, V. A. (1998). The service quality puzzle. *Business Horizon*, (September-October), 35–43.

Berry, Leonard L, Seiders, K., & Grewal, D. (2002). Understanding service convenience. *Journal of Marketing*, *66*(July), 1–17.

Blau, P. M. (1964). *Exchange and power in social life*. New York: Wiley.

Brady, M. K., & Cronin, J. (2001). Some new thoughts on conceptualizing perceived service quality: a hierarchical approach. *Journal of Marketing*, *65*(3), 34–49.

Chomeya, R. (2010). Quality of psychology test between Likert scale 5 and 6 points. *Journal of Social Sciences*, *6*(3), 399–403.

Choudhury, K. (2013). Service quality and customers' purchase intentions: an empirical study of the Indian banking sector. *International Journal of Bank Marketing*, *31*(7), 529–543.

Cooper, D. R., & Schindler, P. S. (2014). *Business research method* (Twelfth Ed). New York: McGraw-Hill Irwin.

Cronin, J. J., & Taylor, S. A. (1992). Measuring service quality: a re-examination and extension. *Journal of Marketing*, *56*(3), 55–68.

Dagger, T. S., Danaher, P. J., & Gibbs, B. J. (2009). How often versus how long: the interplay of contact frequency and relationship duration in customer-reported service relationship strength. *Journal of Service Research*, *11*(4), 371–388.

Dahari, Z., Abduh, M., & Fam, K. S. (2015). Measuring service quality in Islamic banking: importance-performance analysis approach. *Asian Journal of Business Research*, *5*(1), 15-28.

Dhar, R. K., & Kushwah, S. V. (2009). Service quality expectations and perceptions of public and private sector banks in India: a comparative study. *Indore Management Journal*, *1*(3), 34–49.

Dusuki, A. W., & Abdullah, N. I. (2007). Why do Malaysian customers patronise Islamic banks? *International Journal of Bank Marketing*, *25*(3), 142–160.

Eadie, D., MacKintosh, A. M., MacAskill, S., & Brown, A. (2009). Development and evaluation of an early detection intervention for mouth cancer using a mass media approach. *British Journal of Cancer, 101*(2), 73–79.

Ebrahimi, M. R., & Moghadam, A. H. (2012). A survey to recognize the most important dimensions of the service quality of Iran's commercial banks. *Journal of Management Research*, *4*(4), 131–142.

Famiyeh, S., Asante-Darko, D., & Kwarteng, A. (2018). Service quality, customer satisfaction, and loyalty in the banking sector: the moderating role of organizational culture. *International Journal of Quality & Reliability Management*, *35*(8), 1546–1567.

Fathi Vajargah, K., Pardakhtchi, M. H., Abolghasemi, M., & Mohammad Hadi, F. (2011). Quality assurance in training based on the importance/performance analysis model. *Iranian Quarterly of Education Strategies*, *4*(2), 57-65.

Fauzi, A. A., & Suryani, T. (2019). Measuring the effects of service quality by using CARTER model towards customer satisfaction, trust and loyalty in Indonesian Islamic banking. *Journal of Islamic Marketing*, *10*(1), 269-289.

Fonseca, J. R. S. (2009). Customer satisfaction study via a latent segment model. *Journal of Retailing and Consumer Services*, *16*, 352–359.

Ganguli, S., & Roy, S. K. (2011). Generic technology-based service quality dimensions in banking: impact on customer satisfaction and loyalty. *International Journal of Bank Marketing*, *29*(2), 168–189.

Gold, A. H., Malhotra, A., & Segars, A. H. (2001). Knowledge management: an organizational capabilities perspective. *Journal of Management*, *18*(1), 185–214.

Grönroos, C. (2000). *Service management and marketing: a customer relationship management approach.* Univerza v Mariboru.

Grönroos, Christian. (1984). A service quality model and its marketing implications. *European Journal of Marketing*, *18*(4), 36–44.

Hair, J. F., Black, W. C., Babin, B. J., & Anderson, R. E. (2010). *Multivariate data analysis* (7th edn.). Upper Saddle River, New Jersey: Pearson Prentice Hall.

Hair, J. F., Hult, G. T. M., Ringle, C. M., & Sarstedt, M. (2014). *A primer on partial least squares structural equation modeling (PLS-SEM)*. Thousand Oaks: Sage.

Hair, J. F., Hult, G. T. M., Ringle, C. M., & Sarstedt, M. (2017). *A primer on partial least squares structural equation modeling (PLS-SEM)* (2nd Editio). Los Angeles: Sage Publications, Inc.

Hamzah, N., Ishak, N. M., & Nor, N. I. M. (2015). Customer satisfactions on Islamic banking system. *Journal of Economics, Business and Management*, *3*(1), 140–144.

Haron, R., Subar, N. A., & Ibrahim, K. (2020). Service quality of Islamic banks: satisfaction, loyalty and the mediating role of trust. *Islamic Economic Studies*, *28*(1), 3-23.

Haron, S., Ahmad, N., & Planisek, S. L. (1994). Bank patronage factors of muslim and non-muslim

customers. *International Journal of Bank Marketing*, *12*(1), 32–40.
Henseler, J., Ringle, C. M., & Sarstedt, M. (2015). A new criterion for assessing discriminant validity in variance-based structural equation modeling. *Journal of the Academy of Marketing Science*, *43*(1), 115–135.
Höck, C., Ringle, C. M., & Sarstedt, M. (2010). Management of multi-purpose stadiums: importance and performance measurement of service interfaces. *International Journal of Services Technology and Management*, *14*(2/3), 188–207.
Hofstede, G. (1980). *Culture's consequences: international differences in work-related values*. Beverly Hills: Sage.
Imrie, B. C. (2013). The influence of social capital on service quality evaluation. *Management Decision*, *51*(4), 871–889.
Islam, R., Ahmed, S., & Razak, D. A. (2015). Identifying the gaps between customer expectations and perceptions on service quality dimensions of Islamic banks in Malaysia. *International Journal of Quality and Service Sciences*, *7*(4), 424 – 441.
Janahi, M. A., & Al Mubarak, M. M. S. (2017). The impact of customer service quality on customer satisfaction in Islamic banking. *Journal of Islamic Marketing*, *8*(4), 595–604.
Johnston, A. C., & Warkentin, M. (2010). Fear appeals and information security behaviors: an empirical study. *MIS Quarterly*, *34*(3), 549–574.
Karami, M., Malek, M. M., & Dubinsky, A. J. (2016). Cultural values and consumers' expectations and perceptions of service encounter quality. *International Journal of Pharmaceutical and Healthcare Marketing*, *10*(1), 2–26.
Kashif, M., Rehman, M. A., & Pilelienė, L. (2016). Customer perceived service quality and loyalty in Islamic banks. *The TQM Journal*, *28*(1), 62–78.
Kashif, M., Wan Shukran, S. S., Abdul Rehman, M., & Sarifuddin, S. (2015). Customer satisfaction and loyalty in Malaysian Islamic banks : A PAKSERV Investigation. *International Journal of Bank Marketing*, *33*(1), 23–40.
Kassim, N. M., & Bojei, J. (2002). Service quality: gaps in the Malaysian telemarketing industry. *Journal of Business Research*, *5*, 845–852.
Khalifeh, G., & Razavi, S. A. (2012). Quality assurance and evaluation in electronic learning using the importance-performance analysis model. *Interdisciplinary Journal of Virtual Learning in Medical Sciences (IJVLMS), 3*(1), 41–50.
Khamis, F. M. D., & AbRashid, R. (2018). Service quality and customer's satisfaction in Tanzania's Islamic banks: a case study at People's Bank of Zanzibar (PBZ). *Journal of Islamic Marketing*, *9*(4), 884–900.
Kumar, M., Kee, F. T., & Manshor, A. T. (2009). Determining the relative importance of critical factors in delivering service quality of banks: an application of dominance analysis in SERVQUAL model. *Managing Service Quality*, *19*(2), 211–228.
Ladhari, R. (2008). Alternative measures of service quality: a review. *Managing Service Quality*, *18*(1), 65–86.
Ladhari, R., Souiden, N., & Ladhari, I. (2011). Determinants of loyalty and recommendation: the role of perceived service quality, emotional satisfaction and image. *Journal of Financial Services Marketing*, *16*(2), 111–124.
Laroche, M., Uelschy, L. C., Abe, S., & Cleveland, M. Yannopoulos, P. P. (2004). Service quality perceptions and customer satisfaction: evaluating the role of culture. *Journal of International Marketing*, *12*(3), 58–85.
Mahdzan, N. S., Zainudin, R., & Au, S. F. (2017). The adoption of Islamic banking services in Malaysia. *Journal of Islamic Marketing*, *8*(3), 496–512.
Malhotra, N. K., Ulgado, F. M., Agarwal, J., Shainesh, G., & Wu, L. (2005). Dimensions of service quality in developed and developing economies: multi-country cross-cultural comparisons. *International Marketing Review*, *22*(3), 256–278.
Maulan, S., Omar, N. A., & Ahmad, M. (2016). Measuring halal brand association (HalBA) for Islamic banks. *Journal of Islamic Marketing*, *7*(3), 331–354.
Moghavvemi, S., Lee, S. T., & Lee, S. P. (2018). Perceived overall service quality and customer satisfaction: a comparative analysis between local and foreign banks in Malaysia. *International Journal of Bank*

Marketing, *36*(5), 908–930.
Muhammad Awan, H., Shahzad Bukhari, K., & Iqbal, A. (2011). Service quality and customer satisfaction in the banking sector: a comparative study of conventional and Islamic banks in Pakistan. *Journal of Islamic Marketing*, *2*(3), 203–224.
Narteh, B. (2018). Service quality and customer satisfaction in Ghanaian retail banks: the moderating role of price. *International Journal of Bank Marketing*, *36*(1), 68–88.
Oliver, R. L. (1977). Product satisfaction as a function of prior expectation and subsequent disconfirmation: new evidence. In *New dimensions of satisfaction and complaining behaviour* (pp. 2–6). Bloomington : Indiana University.
Osman, 'Ismah. (2011). *The impact of corporate image on customer loyalty of Islamic Banks in Malaysia: Integrating resource-based and institutional theory*. International Islamic University Malaysia.
Othman, A., & Owen, L. (2001). Adopting and measuring customer service quality (SQ) in Islamic Banks: a case study in Kuwait Finance House. *International Journal of Islamic Financial Services*, 3(1), 1–26.
Parasuraman, A., Zeithaml, V. A., & Berry, L. L. (1985). A conceptual model of service quality and its implication for future research (SERVQUAL). *Journal of Marketing*, 49(4), 41–50.
Parasuraman, A., Zeithaml, V. A., & Berry, L. L. (1988). SERVQUAL: A multiple-item scale for measuring customer perceptions of service quality. *Journal of Retail*, 64(1), 14–40.
Prakash, A., & Mohanty, R. P. (2013). Understanding service quality. *Production Planning and Control*, *24*(12), 1050–1065.
Raajpoot, N. (2004). Reconceptualising service encounter quality in non-western context. *Journal of Service Research*, *7*(2), 181–201.
Ravichandran, K., Mani, B. T., Kumar, S. A., & Prabhakaran, S. (2010). Influence of service quality on customer satisfaction application of SERVQUAL model. *International Journal of Business and Management*, *5*(4), 117–124.
Rehman, A. A. (2012). Customer satisfaction and service quality in Islamic banking. *Qualitative Research in Financial Markets, 4*(2/3), 165 – 175.
Ringle, C. M., & Sarstedt, M. (2016). Gain more insight from your PLS-SEM results the importance-performance map analysis. *Industrial Management and Data Systems*, *116*(9), 1865–1886.
Rust, R. T., & Oliver, R. W. (1994). The death of advertising. *Journal of Advertising*, *23*(4), 71–77.
Saunders, S. G. (2008). Measuring and applying the PAKSERV service quality construct: evidence from a South African cultural context. *Managing Service Quality*, *18*(5), 442–456.
Sayani, H. (2015). Customer satisfaction and loyalty in the United Arab Emirates banking industry. *International Journal of Bank Marketing*, *33*(3), 351–375.
Shafie, S., Azmi, W. N. W., & Haron, S. (2004). Adopting and measuring customer service quality in Islamic banks: a case study of Bank Islam Malaysia Berhad. *Journal of Muamalat and Islamic Finance Research*, *1*(1), 2–19.
Shariff, R. A. B. M. (2013). Service quality in Islamic and conventional banks in malaysia: an explorative and comparative analysis. Durham University. Retrieved from http://etheses.dur.ac.uk/7315/
Smolo, E., & Mirakhor, A. (2010). The global financial crisis and its implications on Islamic financial industry. *International Journal of Islamic and Middle Eastern Finance and Management*, *3*(4), 372–385.
Strandberg, C., Wahlberg, O., & Ohman, P. (2012). Challenges in serving the mass affluent segment: bank customer perceptions of service quality. *Managing Service Quality*, *22*(4), 359–385.
Taap, M. A., Chong, S. C., Kumar, M., & Fong, T. K. (2011). Measuring service quality of conventional and Islamic banks: a comparative analysis. *International Journal of Quality & Reliability Management*, *28*(8), 822–840.
Tahir, M. T., & Bakar, N. M. A. (2007). Service quality gap and customers' satisfactions of commercial banks in Malaysia. *International Review of Business Research Papers*, *3*(4), 327–336.
Winsted, F. K. (1997). The service experience in two cultures: a behavioural perspective. *Journal of Retailing*, *73*(3), 337–360.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 119-128
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Islamic Social Finance and Green Finance to Achieve SDGs through Minimizing Post Harvesting Losses in Bangladesh

Taslima Julia*, Anwar Muhammad Noor, Salina Kassim

IIUM Institute of Islamic Banking and Finance, IIUM, Kuala Lumpur, Malaysia

Corresponding author: taslima.julia@yahoo.com

Abstract

The whole world is passing through an unprecedented period and struggling to overcome the economic and financial losses caused by a tiny virus COVID 19. Bangladesh is no exception. The economy of the country is agricultural-based and post-harvesting losses of fruits and vegetables is a significant issue here. This paper tries to investigate the old problem from a different perspective, with a new strategy, hoping to mitigate the impairment. Basically, renewable energy-based cold storage can solve the issue. Green financing, along with Islamic Social Financing, can play a vital role to facilitate the cold storage opportunities to the rural farmers. This paper, following a qualitative research method, is trying to offer a solution to minimize the post-harvesting losses. The implementation of this solution can help the rural mass to get rid of the poverty, hunger and malnutrition problems. In this effort not only good health and well-being will be ensured, but also partnership business practices will be enhanced while guaranteeing affordable clean energy uses. Consequently, the successful implementation of the new strategy can help the country to achieve several sustainable development goals, some directly and some indirectly.

Keywords: Islamic social finance, green finance, post harvesting losses of fruits and vegetables, SDGs

1. Introduction

Bangladesh is mainly based on agriculture and the development of the country largely depends on the development of the agriculture sector which contributes 17 percent of the GDP (BBS, 2015) and 63 percent of the employment (Kabir, 2018). Bangladesh produces about 176,000 metric tons of vegetables annually, of which about 65 percent are produced in winter and the rest in summer. Therefore, production is not well distributed throughout the year (DAE, 2016); to maintain stable supply of vegetables and fruits strengthening post harvesting preservation system is essential. However, due to absence of proper postharvest management system, a bulk quantity of the harvested produce is damaged every year and the farmers sell their hard-earned produce at throw-away prices and incur losses (Kabir, 2018).

The losses basically have two-fold social impacts. Firstly, the country is facing enormous annual monetary loss. Secondly, the consumers are deprived from the consumption of the highly nutritious fruits and vegetables. A considerable proportion of the harvested produce never reaches the consumers mainly because of postharvest losses. The estimated postharvest losses of fruits and vegetables lie in the range of 20-40% throughout the world (Wills et al., 2004). The losses are due mainly to the lack of storage facility, sub-standard postharvest handling practices, inadequate transport, and ignorance of the stakeholders (Hassan 2010). Moreover, in the entire marketing channel, there is no facility for short- and long-term storage of perishables. Ideally, storage facilities should be located at each of the loading and unloading points, and in the wholesale markets. This is a critical problem in the present marketing system, especially for the perishables like fruits and vegetables. Therefore, this article will search the existing literature to get the answer of the question, how is it possible to reduce the post harvesting losses of fruits and vegetables in Bangladesh?

Introduction and establishment of cool chain or small cold storage is a must to reduce postharvest quantitative and nutritional losses, stabilize commodity price, reduce the negative engagement of the

Article history:
Received 18 October 2020
Revised 24 October 2020
Accepted 4 November 2020

intermediaries, and ensure product's quality and safety (Sawicka, 2019). The cool chin at the grip of farmers could reduce the losses in a significant proportion, and thereby, millions of Takas would be saved annually. Though cold storage is extremely necessary for Bangladesh, modern storage of fruits and vegetables is virtually absent in Bangladesh. The constant supply of electricity is necessary for cold storage and the inconsistency of the electricity supply at rural level is the major hindrance for introducing the cold storage. Considering all these factors, if it is possible to introduce mini solar based cold storage in Bangladesh, it will be a revolution in agriculture sector.

The solar mini cold storage will not only save huge amount of produce fruits and vegetables and money but also will create different kinds of employment related to managing these cold storage systems. Moreover, servicing of this equipment will create new employment opportunities in the local region. Broadly, it will help the country to achieve many of the SDGs. The solar mini cold storage is expensive and beyond the capacity of individual farmer to afford it. Therefore, an innovative financing mechanism is required. Keeping all these in mind, this paper will also try to get the answer of the question, what are the possible ways to finance the product that will solve post harvesting losses of fruits and vegetables in Bangladesh? This article will find the answer of the question related to the solar mini cold storage, including green finance with social Islamic finance and by involving banks or non-bank financial institutions under one umbrella. To facilitate the finding, the paper is divided into various sections and the sections begin with literature review, followed by methodologies, finding and discussion and finally the conclusion and recommendations.

2. Literature Review

According to the title of the paper, Islamic Social finance, Green finance, Sustainable Development goals, post harvesting losses of fruits and vegetables literature will be searched to get a solution to the problem. The combined effort of Islamic social finance instruments and green finance supported by banks or nonbank financial institutions can facilitate poor people to own mini solar cold storage in group or collective manner so that all the year-round fruits and vegetables can be stored and kept fresh to get appropriate price.

2.1 Islamic Social Finance

Social finance is a multibillion-dollar approach to manage investments that generate financial returns while having assessable positive social and environmental impact. Though the area is rapidly advancing but remains an under-institutionalized field. Social finance or social investment does not mean a grant or donation, it is still an investment which is repayable and often comes with profit. Islamic social finance is social finance or social investment which follows Shariah rules and principles (Mohd Zain and Engku Ali, 2017).

According to the current practices, Islamic social finance can be divided into three main groups which consist of: (a) Islamic traditional instruments based on philanthropy; examples: zakat, sadaqah and waqf (Abduh 2019; Syed Azman and Engku Ali 2019; Jouti 2019) (b) cooperative-based foundations; examples: *qard al hasana* and *kafala* (Islamic Social Finance Report, 2015). (c) Other modern forms of Islamic financial services; examples: Islamic microfinance, sukuk and takaful waqf (Jouti 2019), socially-impactful Islamic crowdfunding (Syed Azman and Engku Ali, 2019).

From the Islamic finance viewpoints many scholars have discussed the Sustainable Development Goals (SDGs) (Gundogdu, 2018). According to few Islamic finance scholars the SDGs are aligned with the philosophy of Islamic finance and therefore, Islamic finance is the novel finance substitute to achieve SDGs in 2030 (Zarrouk, 2015). Three Islamic social finance instruments namely infaq, waqf and zakat are excellent alternative philanthropic fund to cover global SDG's investment gap; SDG no. two that is "end hunger, achieve food security and improved nutrition and promote sustainable agriculture" is possible to achieve through Islamic social finance (Abduh, 2019). Islamic finance could promote agricultures sustainability and a more efficient process with FinTech enabled platform (Ningrat and Nurzaman, 2019). Therefore, Islamic social finance crowdfunding platform can be a possible financing source to finance the solar mini cold storage to reduce post harvesting losses of fruits and vegetables.

2.2 Green Finance

Bangladesh central bank, that is Bangladesh Bank, had inaugurated green banking policy and guideline in 2011 and has made it compulsory to all banks and nonbank financial institutions to create their own green banking units, guide and branch. Since then each bank in Bangladesh is providing green financing to green clients (GBPG Circular 2 2011). Green financing helps to create green businesses, according to banking policy green clients are involved in eleven categories of green business such as renewable energy, energy efficiency, solid waste management, liquid waste management, alternative energy, fire burnt brick, non-fire block brick, recycling and recyclable product, green industry, safety and security of factories and miscellaneous. Among the eleven categories there are 47 product lines (GBPG Circular 4 2014).

Green finance comprised financing of (including preparatory cost and capital cost) green investments, financing of public green policies and green financial system (Linderberg, 2014). According to the *Deutsche Gesellschaft für Internationale Zusammenarbeit* (GIZ), green finance is a strategic approach to incorporate the financial sector in the transformation process towards low-carbon and resource-efficient economies, and in the context of adaptation to climate change (GIZ, 2011). Green businesses adopt principles, policies and practices that improve the quality of life of the customers, employees, communities, and the planet. Green businesses are socially and environmentally responsible and challenge themselves to bring the goals of social and economic justice, environmental sustainability, as well as community health and development. Green businesses improve communities.

Rural clients, who most of the cases are farmers, are deprived from the banking services. Green financing is such a platform that can bring banking services at the doorstep of rural households. In Bangladesh context besides banks, non-bank financial institutions had extended green financing to green projects or renewable energy sectors to install solar home system to poor people houses. Infrastructure and Development Company Limited (IDCOL), Sustainable and Renewable Energy Development Authority (SREDA) etc. are playing remarkable role in this regard. In Bangladesh, Islamic banks are performing well in case of green financing compared to conventional counterpart, moreover, Shariah relevance of green banking policy is a motivational factor to involve Islamic banks more in green financing (Julia and Kassim, 2019, 2020; Julia et al., 2016). Consequently, Islamic social finance along with green financing can accumulate huge financing for mini solar cold storage.

2.3 Sustainable Development Goals (SDGs)

UN Sustainable Development Summit was held in New York from 25-27 September 2015 for the adoption of an ambitious, bold and universal sustainable development agenda that will end poverty and promote prosperity by 2030, while addressing the environment. The summit outcome document, entitled "Transforming our World: The 2030 Agenda for Sustainable Development," was agreed on by the 193 member states of the United Nations, and includes 17 Sustainable Development Goals and 169 targets (GRI & UNGC, 2016). The seventeen goals are- no. 1 no poverty, no. 2 zero hunger, no. 3 good health and well-being, no. 4 quality education, no. 5 gender equality, no. 6 clean water and sanitation, no. 7 affordable and clean energy, no. 8 decent work and economic growth, no. 9 industry innovation and infrastructure, no. 10 reduced inequality, no. 11 sustainable cities and communities, no. 12 responsible consumption and production, no. 13 climate action, no. 14 life below water, no. 15 life on land, no. 16 peace, justice and strong institutions and no. 17 partnerships for the goals.

To appreciate the SDGS understanding, five P's are vital. They are People, Planet, Prosperity, Peace and Partnership. These five P's are considered as elements of SDGs and three of them are the pillars of SD: People, Planet and Prosperity. The 2030 Agenda is indivisible. Therefore, countries should avoid cherry picking goals and carefully assess the trade-offs across goals or targets. SDGs are very comprehensive and designed to achieve universal goals which are agreed by the world community in general and have no direct conflicts with Islamic percepts. The sustainable development discourse has, however, acknowledged that the three pillars of sustainable development need to be completed by an ethical dimension at the level of popular values. The World Summit on Sustainable Development in Johannesburg (2002) added a short paragraph 6 to its Programme of Action: "We acknowledge the importance of ethics for sustainable development and, therefore, emphasize the need to consider ethics in the implementation of Agenda 21" (WSSD, 2002).

Green financing is an initiative of sustainable development program and Islamic finance can play a great role to achieve sustainable development goals, hence, combination of Islamic finance, green finance and

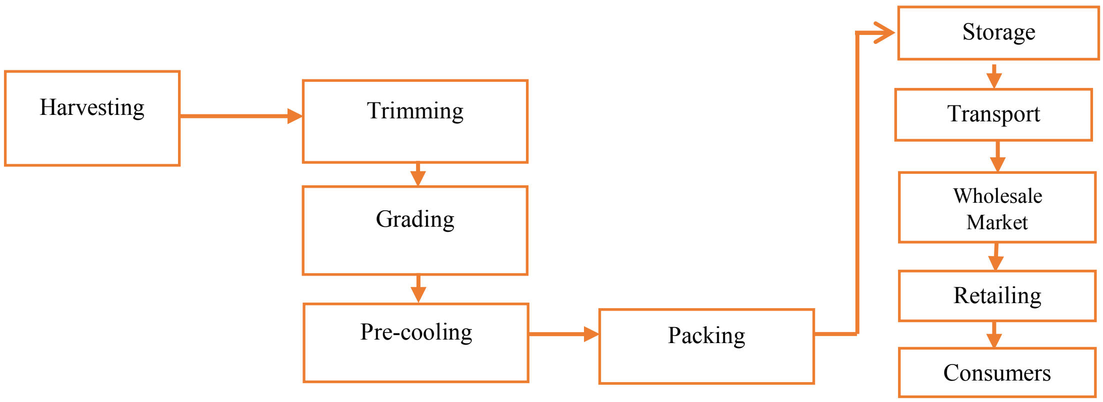
Islamic social finance can play a pivotal role to achieve many of the SDGs. This financing combination can also solve post harvesting loss problem and many other problems related to that.

2.4 Post Harvesting Losses

In Bangladesh the vegetables production rises by one-third in the last 5 years that is 37.63%, between 2013-2014 and 2018-2019 fiscal years (Hasan, 2020). Although production increases, negligible actions has been taken to reduce the post harvesting losses (PHL). Postharvest loss is often used to describe "losses between harvest and the onward supply of produce to markets and equates broadly with waste in the food supply chain" (Gogh et al., 2013). According to officials at the Department of Agricultural Extension (DoAE), though there is larger production amount, but the postharvest loss is almost 40% in Bangladesh and in other developing countries. The estimated postharvest loss of fruits and vegetables in Bangladesh is 23.6%-43.5%. The total loss was found to be the highest in jackfruit followed by pineapple (43.0%), papaya (39.9%) and cauliflower (27.1%). Hence, loss reduction strategies must be strengthened right from the beginning. Results suggested that around 3442 Crore Takas or 344.2 Million Takas are lost every year due to postharvest spoilage of some selected fruits and vegetables (Hassan et al., 2010) .

The contribution of fruits and vegetables remains extremely important for ensuring food and nutritional security in Bangladesh. The food and nutrition situation in Bangladesh are fragile due to inadequate and imbalanced diet intake. Fruits and vegetables are highly valued in human diet mainly for vitamins and minerals. However, the present consumption of fruits and vegetables in Bangladesh is 126 g/day/capita which is far below the minimum average requirement of 400 g/day/capita (FAO/WHO, 2003). Consequently, the high levels of low birth weight (33%), underweight (41%), stunting (43%) and wasting (17%) among children less than five years; anemia among infants, young children, adolescent girls and pregnant women are very common (BCIP, 2010; BDHS, 2009). The prevalence of overweight (12.5%) among women that has increased by 10% between 2004 and 2007 also indicates the existence of double burden of malnutrition in Bangladesh (BDHS, 2009), which also impacts the macro economy of the country and a major hindrance to achieve the SDGs.

Figure 1: Flow diagram on harvesting and post harvesting handling steps of horticultural produce



Sources: (Hassan et al., 2010)

In addition, the price of commodity at different levels of supply chain is very important in Bangladesh, where the commodity price varies quite significantly due to the engagement of numerous intermediaries in the system. The price of produce is high at the retailers' level as compared to that of the growers' level. High price increase of a commodity at the retail level is possibly attributed to the less market integration and vice-versa. Price analyses of horticultural commodity at different levels of marketing showed that the increase in price ranged from 44.52% (mango) to 252.35% (red amaranth) at the retailers' end when compared with the growers' sales price. More than 100% price increase was observed in pineapple, jackfruit and tomato. The levels of price increase in cucumber, banana, cauliflower and okra were 94.31%, 89.48%, 88.13% and 86.40%, respectively (Hassan et al., 2010). The average increase in price of fruits and vegetables is 105% in the marketing channel before reaching the consumers. The main reason is that the lake of storage facilities in postharvest stages of the products, farmers fear that their hard-earned products will be perished if they cannot

sell to the local intermediaries on the field. The supply chain of horticultural produce in Bangladesh has various parties' involvement such as grower, dealer (*Baperi*) wholesaler, retailers and consumer. The above Figure 1 indicates the flow diagram of harvesting and post harvesting handling steps of horticultural produce.
During this pandemic situation when the whole country was lock down due to COVID-19, the farmers worked tirelessly round-the-clock however instead of their hard work they could not change the miserable conditions. Many traders from cities and deficit zones could not visit the producing zones, particularly in the distant districts from Dhaka, because of the absence of public transport, therefore, many farmers failed to get enough buyers to sell their produce at an appropriate price (Parvez, 2020). Because of limited buyers, they sold perishable produce at low price and felt the extreme need of the cold storage facilities; if there was cold storage available, they could store those produce and could trade them when price is appropriate.

2.5 Solution Available to Reduce Post Harvesting Losses

After extensive literature survey the following solution to reduce PHL of fruits and vegetables are observed. In Bangladesh, to reduce the PHL of fruits and vegetables farmers are widely applying formalin to preserve the perishable products fruits, vegetables, meat and milks for long time, however, this chemical is posing a massive threat to the public health and nutrition at an alarming level. Food contamination with toxic chemicals has reached an astounding level in Bangladesh (Kamruzzaman, 2016). Pineapples are treated with formalin to protect against microbial attack after harvesting and it combats financial loss. For quick growth and ripening, various hormones and toxic chemicals are being used continuously by farmers in Bangladesh. Without knowing the health hazard people are consuming the contaminated fruit and suffering from health problems like respiratory, neurological, immunological, hematological, reproductive, cardiovascular, developmental, dermal, genotoxic and gastrointestinal causes for consumption of this contaminated pineapples (Proshad et al., 2018).

The Horticulture Development Centre of Bangladesh Agricultural Development Corporation (BADC) in 2013 has set up a cold storage at Jhumjhumpur, in Jessor district to preserve fruits, flowers, vegetables, meat and fish. However, considering the high cost, the weekly and monthly costs for storing vegetables stand at 25.20 Taka and 108 Taka respectively per kilo, farmers are reluctant to store produce there claiming that the rates are not favorable for business (FreshPlaza, 2016). Though the importance of cold storage is extremely necessary for Bangladesh, modern storage of fruits and vegetables is virtually absent in Bangladesh. Cold storage facility is only available for potato and very insignificant number for imported fruits. The collective potato cold storage facility for small-scale farmers in Bangladesh can be a way to resolve PHL of potatoes (Douma, 2016).

In India, to solve the PHL problem as well as to save the environment from the harm of diesel made cold storage, three alumni of IIT Kharagpur has provided an impactful solution to the agro-community. The solution is known as Ecozen Solutions. The best way towards developing a clean, non-exhaustible and optimized technology was by harnessing solar energy. Ecozen's solar-powered cold room, called Ecofrost, is designed to help farmers store fresh produce until it reaches end consumers. Expanded shelf life of crops enables the farmers to earn more and reduce postharvest losses. The startup targets agro-traders, wholesalers, retailers and farmers (SmartWorld, 2018).

Controlling PHL can reduce the hunger problem in the developing countries. Both developed and developing countries are applying three strategies to resolve the PHL problem. Firstly is the application of current knowledge to improve the handling systems. Secondly, overcoming the socioeconomic constraints, such as inadequacies of infrastructure, poor marketing systems, and weak R&D capacity, and thirdly, encouraging consolidation and vertical integration among producers and marketers of horticultural crops (Kumar et al., 2015).

2.6 Literature Gap

To prevent the PHL of fruits and vegetables, among many recommendations by Hassan et al (2010), one is mentionable here that is the public private partnership. The researchers had emphasized on introducing new and modern postharvest technologies like low temperature storage, refrigerated transport vehicle, ethylene induced ripening technology and plastic packaging and the dissemination of low-cost storage technology at farmers' doorsteps. Generally, the losses were greater at the hands of the intermediaries, especially the dealer (*Bepari*) and wholesalers due to improper supply chain. The growers generally sell their produce either to the broker (*Faria*) in their own field or to the dealer in the nearby rural markets. Subsequently, they never get their expected price from the market. This scenario could be changed if the chain can be introduced at the reach of the farmers. It is recognized that the intermediaries are also vital components of today's business. Therefore, they could not be excluded from the supply chain. Nevertheless, if cold storage is possible to be introduced at the reach of the farmers, the bargaining power of the poor farmers will be increased and monitoring will be strengthened in order to reduce the negative influence of the intermediaries in fruits and vegetables supply chain. This would ensure two-fold benefits, firstly, the growers would receive reasonable price of their produce, and secondly, the consumers would purchase produce at reasonably lower prices. However until to-date, no initiatives have been taken in Bangladesh to set up cold chain in extensive manner. Therefore, there is a gap that needs to be filled.

3. Methodology

Based on literature review approach, this study attempts to find possible solution to lessen the post harvesting loses of fruits and vegetables in Bangladesh. It has been identified that solar based mini cold storage facilities can solve the problem significantly. The model used by EcoFrost seems appropriate to handle unique natured vegetables and fruits which require different level of temperature to preserve the freshness as well as the nutrients (Hassan et al., 2010; SmartWorld, 2018). Financing is an issue, keeping in mind that solar based mini cold storage facility is expensive, approximately 2 Million to 1.5 million Taka per storage, therefore, this study will offer a unique funding method including green financing and Islamic social financing as mechanism based on authors' analytical abilities and literature reviewed. Considering the country's legal and socio-economic background, the appropriateness of the offered solution is justified.

4. Finding and Discussion

The solar mini cold storage solution, invented by Ecozen, seems appropriate to resolve PHL condition in Bangladesh as well. However, the financing mechanism will be different. Although the projects are subsidy driven, the product cost varies depending on different customer requirements, markets and regions. Solar power helps users to save major running costs on electricity or fuel. In most cases, the company followed lease-based business model and the model received positive responses from buyers. The system has especially helped horticulture farmers, who have specific season-based production in the year, by allowing leasing the system whenever required.

The system comes with a five year maintenance contract. The return on investment (ROI) solely depends on the mode of usage and the commodity stored inside the system. The crops which are highly perishable, highly valued, ensure good returns. The payback period is two to three years of use; however, regular crop production may take slightly longer payback time. The web and mobile applications bring the sellers (farmers and perishable crop growers or vendors) and buyers (organized retailers, fresh e-commerce players, wholesalers or traders) in one platform to trade. Therefore, it enables both parties to transport the commodities in a refrigerated truck from source to destination that allows maintaining the quality of produce.

The advantages of the solar micro cold storage are enormous. It uses renewable energy that is solar power the storage capacity is five metric tons, hybrid in nature, therefore, can use both grid electricity and solar power. During cloudy weather, the system automatically switches to the available alternative power supply, notifying the operator. The temperature varies from 2-10 to 10-12 degrees Celsius, relative humidity is 80-95 percent. It also has pre-cooling capacity; it requires less battery and portable. It is controlled by report and prognosis which not only helps run the system but also charges the thermal plates installed inside, that can provide backup up to 30 hours. These thermal batteries have at least twice the life compared to conventional solar batteries and lower replacement costs that reducing running costs significantly.

Figure 2: Solar Mini Cold Storage

(Sources: SmartWorld, 2018)

4.1 Mechanism of Financing

The solar mini cold storage is expensive (per cold storage cost about 2 Million to 1.5 Million) and beyond the capacity of individual farmer. However, farmers can collectively afford it and own it, for this one party is required to combine them, train them and help them to manage the whole process including getting financing. The party can be a green company or cooperative society. One cold storage can be used by many to preserve different variety of fruits and vegetables one by one throughout various seasons. On other way, farmers can use the cold storage upon needed, rental basis and green companies can provide the services to farmers as well as all other parties in the supply chain. In this case green company will own the cold storage. This study offers three ways of managing financing to be affordable in Bangladesh. Table 1 represents financing mechanism, parties involved, sources and process of financing.

Table 1: Solar Mini Cold Storage Financing Mechanism

Owner of Cold Storage	Financier	Process
Farmers	Green financing scheme of Banks and non-bank financial institutions. Agricultural bank (state-owned specialized bank)	Step1-There are 60 schedule banks, 34 financial institutions (FIs), 3 state-owned specialized banks in Bangladesh. Currently, all are practicing green financing. Step2-Green companies on behalf of farmers or farmers themselves collectively can approach Agricultural bank or any other banks or FIs for soft loan with grant facilities to buy the solar mini cold storage. Step3-Green companies will provide servicing as well as help banks to get repayment of loan installments on time. Step4- Green companies as seller of product will manage the product and the farmers as owner will use the product throughout the year according to their need and harvesting type.
Green Companies	Green Financing scheme of banks and nonbank financial institutions	Step1- Green companies can approach for financing facilities to any bank or Infrastructure and Development Company Limited (IDCOL) or Sustainable and Renewable Energy Development Authority (SREDA) to buy the product. Step2- Green Company then will provide the storage facilities to rural people and farmers according to their needs on rental basis. Step3- Farmers will be hassle free as they need not to think about the servicing or maintenance. Step4- Green companies will be liable to pay bank installments.
Farmers or Green companies	Islamic Social Financing - Crowdfunding Platform	To handle the coronavirus pandemic situation and to help the poor as well as small business to overcome the crisis, the Information and Communication Technology Division State Minister has inaugurated first digital crowd-funding platform, Ekdesh on May 2020. The platform is accumulating zakat or financial aid (Dhaka Tribune, 2020).

	Therefore, it is quite possible to create another platform to finance solar mini cold storage. The Food and Agricultural ministry in collaboration with Information and Communication Ministry can take initiative to help green companies or farmers directly through crowd funding platform. Obviously, that would be investment platform. Banks from green financing scheme, IDCOL, SREDA all other parties could join in this platform as investors. Consequently, the large amount of investment could help farmers or green companies to buy remarkable number of storage facilities to lessen the PHL of highly valuable fruits and vegetables.

4.2 Achieving SDGs

If the proposed financing mechanism is possible to be implemented successfully, a revolutionary will occur in the Bangladesh agricultural sector. The strategies that will reduce PHL, will simultaneously achieve few SDGs directly such as SDG no. one- no poverty, SDG no. two- zero hunger, SDG no. three- good health and wellbeing, SDG no. seven- affordable and clean energy, SDG no. eight- decent work and economic growth and SDG no. seventeen- partnership for the goals. Few SDGs will be achieved indirectly too those are SDG no. nine- industry, innovation and infrastructure, SDG no eleven- sustainable cities and communities and SDG no. twelve responsible consumption and production.

5. Conclusion and Recommendation

Post harvesting loses of fruits and vegetables is an important hindrance to grow country's economy, however, solving the issues can resolve many problems such as hunger, malnutrition, overweight, health hazard, over pricing of commodities and will ensue farmer's gain, their good health and wellbeing, increases employments etc. Recently, the growth rate of the agriculture sector and its contribution to the country's economy have dropped (Murtuza, 2019). Negligence to the sector would affect employment of the country as well as government's development goals including achieving 8.2 percent gross domestic production (GDP) growth and sustainable development goals (SDGs). The unprecedented event of pandemic is going to deteriorate the scenario of PHL and currently farmers are feeling the extreme need of cold storage facilities (Parvez, 2020). Solar mini cold storage can solve the PHL issue and the mini cold storage with average 5-10 tons capacity will be the best alternative sources of dependable, sustainable, cost effective and environment friendly solution to postharvest storage problem. Considering the environmental factors and agricultural scenario of Bangladesh, solar mini cold storage market opportunity is huge. This study tried to offer three financing solutions to afford the mini cold storage. However, authors are strongly recommending the third financing solution that is the Islamic social financing crowdfunding platform where as an individual investor, Islamic banks with green financing, conventional banks and non-bank financial institutions with green financing could take part, therefore, the accumulated fund will be huge which would support the purchase of bulk amount of solar mini cold storages. Consequently, the massive installation of mini cold storage could drastically reduce the PHL of fruits and vegetables and could help the country to attain the sustainable development agenda.

Acknowledgement

The paper has been presented at the International Conference on Islamic Social Finance: Pandemic Crisis and Possible Solutions (Online) organized by the IIUM Institute of Islamic Banking and Finance on 29th – 30th September 2020. We thank the reviewers and the Journal Editor for the constructive comments for further improvement of the paper.

References

Abduh, M. (2019). The role of Islamic social finance in achieving SDG number 2: end hunger, achieve food security and improved nutrition and promote sustainable agriculture. *Al-Shajarah* (Special Issue Islamic Banking and Finance), 185–206.

BBS. (2015). *Statistical year book of Bangladesh*. Dhaka, Bangladesh: Bangladesh Bureau of Statistics, Ministry of Planning, Govt. of Bangladesh.

BCIP. (2010). *Bangladesh country investment plan: a road map towards investment in agriculture, food*

security and nutrition. Dhaka, Bangladesh.
BDHS. (2009). *Bangladesh demographic and health survey 2007*. Dhaka: Bangladesh and Marco International, Maryland, USA.
Circular2, B. (2011). *Policy guidelines for green banking*. Dhaka: Bangladesh.
Circular4, G. (2014). *Policy guidelines for green banking*. Dhaka. Bangladesh.
DAE. (2016). *Agricultural extension manual*. Dhaka: Bangladesh.
Dhaka Tribune. (2020). Bangladesh's first digital crowd-funding platform Ekdesh launched. Retrieved September 27, 2020, from https://www.dhakatribune.com/bangladesh/2020/05/15/bangladesh-s-first-digital-crowd-funding-platform-ekdesh-launched
Douma, A. (2016). Collective potato cold storage facility for small-scale farmers in Bangladesh. Retrieved September 27, 2020, from https://challenges.openideo.com/challenge/agricultural-innovation/improve/communal-cold-storage-facility-and-knowledge-center-for-small-scale-potato-farmers
FAO/WHO. (2003). *Diet, nutrition and the prevention of chronic diseases*. Geneva: WHO.
FreshPlaza. (2016). Bangladesh: High cold storage costs deter farmers. Retrieved September 27, 2020, from https://www.freshplaza.com/article/2165264/bangladesh-high-cold-storage-costs-deter-farmers/
GIZ. (2011). *Green finance- an innovative approach to fostering sustainable economic development and adaptation to climate change*. Bonn and Eschborn, Germany.
Gogh, B. Van, Aramyan, L., Sluis, A. Van Der, Soethoudt, H., & Scheer, F. (2013). *Feasibility of a network of excellence postharvest food losses*. Wageningen UR, Netherland.
Gundogdu, A. S. (2018). An inquiry into Islamic finance from the perspective of sustainable development goals. *European Journal of Sustainable Development*, *7*(4), 381-390.
Hasan, K. (2020). Vegetable production rises by one-third in 5 years. Retrieved September 27, 2020, from https://www.dhakatribune.com/bangladesh/2020/01/03/vegetable-production-rises-by-one-third-in-5-years
Hassan, M. K., Chowdhury, B. L. D., & Akhter, N. (2010). Post harvest loss assessment : a study to formulate policy for loss reduction of fruits and vegetables and socioeconomic uplift of the stakeholders. Final Report (PR 8/08), 166-167.
Hassan, P. D. M. K. (2010). *A guide to postharvesting handling of fruits and vegetables*. (P. C. S. P. National, Research Grants Scheme (RGS) of the (NFPCSP)., Ed.). Department of Horticulture Bangladesh Agricultural University Mymensingh.
Julia, T., & Kassim, S. (2019). How serious are Islamic banks in offering green financing?: an exploratory study on Bangladesh banking sector. *International Journal of Green Economics*, *13*(2), 120-138.
Julia, T., & Kassim, S. (2020). Exploring green banking performance of Islamic banks vs conventional banks in Bangladesh based on Maqasid Shariah framework. *Journal of Islamic Marketing*, *11*(3), 729-744
Julia, T., Rahman, M. P., & Kassim, S. (2016). Shariah compliance of green banking policy in Bangladesh. *Humanomics*, *32*(4), 390–404.
Kabir, M. S. (2018). Status of vegetable production and marketing in Bangladesh. In *Seminar Paper to the Department of Agricultural Extension and Rural Development*. Salna, Gazipur: Bangabandhu Sheikh Mujibur Rahman Agricultural University.
Kamruzzaman, M. (2016). Formalin crime in Bangladesh: a case study. *European Journal of Clinical and Biomedical Sciences*, *2*(5), 39–44.
Kumar, V., Shankar, R., & Kumar, G. (2015). Strategies used for reducing postharvest losses in fruits and vegetables. *Internationall Journal of Scientific & Engineering Research*, *6*(5), 130–137.
Linderberg, N. (2014). Definition of green banking. Retrieved September 27, 2020, from https://collaboration.worldbank.org/content/sites/collaboration-for-development/en/groups/green-finance-community-of-practice/documents.entry.html/2018/08/25/definition_of_green-mp3F.html
Mohd Zain, N.R., & Engku Ali, E. R. A. (2017). An analysis on Islamic social finance for protection and preservation of Maqāṣid al- Sharī'ah. *Journal of Islamic Finance* (Special Issue), 133–141.
Murtuza, H. (2019). Agriculture's share in GDP drops amid lack of govt support. Retrieved September 15, 2020, from https://www.newagebd.net/article/75369/agricultures-share-in-gdp-drops-amid-lack-of-govt-support
Ningrat, G., & Nurzaman, M. S. (2019). Developing fintech and Islamic finance products in agricultural

value chain. *Journal of Islamic Monetary Economics and Finance*, *5*(3), 491–516.

Parvez, S. (2020). Cold storage can save farmers from ruins. Retrieved September 27, 2020, from https://www.thedailystar.net/business/news/cold-storage-can-save-farmers-ruins-1902475

Proshad, R., Islam, M. S., Islam, M. N., Hossain, M. R., Kormoker, T., Islam, M. S., & Billah, K. M. M. (2018). Promiscuous application of toxic agrochemicals on pineapple: Health hazard implications in Bangladesh. *Food Research*, *2*(2), 139–145.

Sawicka, B. (2019). Post-harvest losses of agricultural produce. In *Springer Nature Switzerland AG, Zero Hunger* (pp. 654–669). Springer.

SmartWorld. (2018). Ecofrost: made in India solar-powered cold storage to reduce crop spoilage. Retrieved September 27, 2020, from https://smart.electronicsforu.com/ecofrost-made-in-india-solar-powered-cold-storage/

Syed Azman, S. M. M., & Engku Ali, E. R. A. (2019). Islamic social finance and the imperative for social impact measurement. *Al-Shajarah* (Special Issue Islamic Banking and Finance), 43–68.

Jouti, T. A. (2019). An integrated approach for building sustainable Islamic social finance ecosystems. *ISRA International Journal of Islamic Finance*, *11*(2), 246–266.

Wills, R., McGlasson, B., Graham, D., & Joyce, D. (2004). *Postharvest: introduction to the physiology and handling fruits, vegetables and ornamentals*. Sydney, Australia: University of New South Wales Press Ltd.

WSSD. (2002). *The* world summit on sustainable development. Johannesburg, South Africa. Retrieved from http://www.cepal.org/rio20/

Zarrouk, J. (2015). The role of Islamic finance in achieving sustainable development. Retrieved, from https://www.un.org/esa/ffd/ffd3/blog/role-of-islamic-finance-in-achieving-sustainable-development.html

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 129-137
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Islamic Bank Dispute Resolution and Socioeconomic Rights: Comparison between Indonesia and Malaysia

Deden Misbahudin Muayyad[a*], Hani Adhani[b]

[a]*Faculty of Economic and Business, Trisakti University, Indonesia*
[b]*Substitute Registrar Constitutional Court of Republic of Indonesia, Indonesia*

[*]*Corresponding author: deden.misbahudin@trisakti.ac.id*

Abstract

The purpose of this study is to identify dispute resolution mechanisms for Islamic banks in Indonesia and Malaysia and to analyze the role of courts in resolving Islamic banking disputes to protect the economic and social rights of communities. This study uses secondary data, such as data obtained from library research, Quran, Hadith, *fatwa*, Islamic banking law, regulations on solving Islamic banking disputes, articles and books. The study concludes that the principles of dispute resolution for Islamic banking in Indonesia and Malaysia are in principle almost the same, as they both use the *Ṣulḥ* and *Taḥkim* methods in resolving disputes other than through litigation. Although the process in Indonesia is more numerous and tiered, it can even be tested for the law to the constitutional court. The most powerful form of constitutional recognition is the recognition of socio-economic rights as rights, which can be enforced judicially in a fair manner, and civil and political rights are usually implemented in this way. The role of the court is to achieve the constitutionality of laws that support social and economic rights.

Keywords: Islamic bank, dispute, court

1. Introduction

As a Muslim-majority country, Indonesia seeks to achieve the Islamic economy by enacting a rule or law on Islamic banking (Law No. 21 2008). The purpose of the law is in line with the goal of Indonesia's national development contained in the fourth paragraph of the Constitution of Indonesia 1945, which protects all Indonesian islands, promotes public welfare, develops the intellectual life of the country, and participates in the implementation of world order, based on independence, lasting peace and social justice. Law No. 21 directly regulates all matters relating to Islamic banking, starting with licensing, legal entity forms, bylaws, ownership, governance, prudential principles, Islamic bank risk management, guidance and supervision, and dispute resolution.

Related to the settlement of disputes in Islamic banks, it has been proven that there are many restrictions, especially because of the contradiction or overlap of the principles of freedom of contract stipulated in the civil code, which stipulates that all contracts (agreements) are legally applicable to the law as a person. The existence of contractual freedom ultimately enables Islamic bank customers to sign agreements without complying with the standard rules of Islamic banking law. The Islamic bank disputes stipulated in Article 55 of the Islamic bank law covers, first, Islamic banking dispute resolution is carried out by a court in a religious court environment; second, if the parties agree to resolve disputes other than those mentioned in paragraph 1, the dispute resolution shall be based on the content of the agreement; and third, the dispute settlement referred to in paragraph 2 shall not contravene the principles of Islamic law.

The overlap of these rules will certainly lead to legal uncertainty and may harm users of Shariah banking services, including Islamic banks or Islamic window banks. Before allocating financing to clients, the Islamic

Article history:
Received 5 November 2020
Revised 11 December 2020
Revised 14 December 2020
Accepted 15 December 2020

window banks must sign a written agreement with other parties that include the rights and obligations of the parties by following accordance with Islamic law principles (hereinafter referred to as contracts).

On August 12, 2012, an Islamic bank client living in Bogor City applied to “Islamic Law”, which specifically deals with the settlement of Islamic law disputes, namely Islamic Law Bank Article 55, Section 2 and paragraph 3. The petitioner stated in the petition that he had lost his constitutional right to legal protection and certainty, as well as the equal treatment before the law guaranteed by article 28D, paragraph 1, of the Constitution 1945. Specifically, the loss was caused by the applicant's client as a branch of Bank Muamalat Indonesia, Tbk Bogor, which signed the contract form on July 9, 2009, and has been renewed with *Musyarakah* financing agreement (on extension of time and collateral modification) No. 14 of March 8, 2010, followed by a dispute with Muamalat Bank, but the dispute resolution procedure did not clearly identify the jurisdiction designated to resolve contractual disputes. According to the petitioner, the existence of freedom of choice led to various interpretations, particularly as to whether the judiciary, by following article 55, paragraph 2, of the Islamic Law, whether the parties chose or promised to comply with Islamic law principle. According to the petitioner, this creates legal uncertainty because article 55, paragraph 1, of the Islamic Law, clearly states that in the event of a dispute, it must be carried out in a religious court environment.

On August 29, 2013, the Constitutional Court of the Republic of Indonesia responded to constitutional issues and approved a part number of petitions to review Article 55, paragraph 2, of the Islamic Law. The court explains that the Law on Islamic Banking No. 21 contradicts with the Constitution 1945 and states that it has no binding legal effect.

On the legal front, the Constitutional Court stated that the Islamic banking dispute between the client and the Islamic window bank was caused by a party who was dissatisfied or unfavorable. In principle, the parties to the dispute have the right to determine the preferred mechanism for dispute resolution by following the principles of Islamic law, namely the principle of Islamic law in the *fatwa*-based banking activities issued by the institutions that determine the *fatwa* of the Shariah.

The same as in Indonesia, although with different cases, in Malaysia there are several cases related to disputes between customers and Islamic banking. For instance, in 1987, Tinta Press Sdn Bhd signed a case with Bank Islam (Malaysia) Bhd. The case involved *ijarah* (leasing) and restructured *ijarah*. According to the lease agreement for its letter of credit financing instrument (abbreviated as *ijarah*), Bank Islam Bhd has leased its printing equipment to Tinta Press. Tinta Press defaulted on paying monthly rent. The Bank sued to recover the arrears of rent and own equipment. Tinta reported that the contract was an *ijarah* rather than a bank loan. The question facing the court is whether *ijarah* constitutes an interest-based loan agreement and whether the bank has the right to take back the goods that are the subject of *ijarah*. The court held that, according to the express terms of the contract, the disputed facility was a lease agreement and the bank had the right to recover the subject matter. Tinta Press appealed, but the Supreme Court confirmed the decision of the Lower Court. If it thinks the agreement is a loan, it means that the bank has no right to take back the printing equipment. The Supreme Court further held that Tinta Press explicitly violated the above lease agreement and therefore the bank has the right to take back the property immediately. Although the court used the common law approach to establish an agreement rather than applying the principles of Shariah in the interpretation, it supported Shariah by ruling that the agreement was a form of *ijarah*. The property's ownership is deposited with the bank and transferred to Tinta Press upon full payment. If the court uses the Shariah lens to view the transaction, it basically following Islamic law.

In 2009, Tan Sri Abdul Khalid bin Ibrahim vs Bank Islam Malaysia Bhd involved the reconstruction of the *Bai’ Bithaman‘Ajil* (BBA) case. The court faced the question of whether the BBA agreement was urgently supported by Islamic law. In deciding the case, the court acknowledged the challenges faced by civil courts in determining Islamic financial disputes. The court further elaborated on the challenges, including the application of the source of the law, as well as the substitution of views when there was a conflict between the relevant *mazhab* (juristic school of thoughts) views and the priority laws of the conflict between Islamic law and civil law. Therefore, the court requested the compilation of Shariah principles applicable to Islamic finance and the development of the necessary conflict of laws guidelines for Shariah.

Based on this background, the purpose of this study is to find out the dispute resolution mechanism of Islamic Banks in Indonesia and Malaysia and to analyze the role of courts in the settlement of disputes in Islamic Banks to protect the economic and social rights of the community.

2. Literature Review

The establishment of an Islamic Bank in Indonesia began in the 1990s. The definition of an Islamic Bank based on Article 1 No. (7) of the Islamic banking law is a bank that conducts business activities based on Shariah principles, and by type consists of Shariah commercial banks and Shariah rural financing banks. Whereas the understanding of Islamic banking is based on Article 1 No (1) of the law on Islamic Banking, which is all that concerns Islamic banks and Shariah business units, including institutions, business activities, as well as ways and processes in carrying out their business activities. The first Islamic bank to be established in Indonesia was Bank Muamalat Indonesia. In its development, there have been many Islamic banks that apply Shariah principles, including BNI Syariah, BRI Syariah, Bank Syariah Mandiri, BTN Syariah, Bukopin Syariah, Danamon Syariah, Bank Mega Syariah.

The legal relationship between banks and customers is part of *muamalah* (transaction) activities. In Islamic law, *muamalah* in a broad sense is the rules (law) of God to regulate human beings concerning worldly affairs in social relations (Munib, 2018). The main legal basis in the operations of Islamic banks is the Quran, Hadith, *Ijma*, and *Ijtihad* of the scholars; for instance (Al Baqarah verse 275; Ali Imran verse 130; An Nisa verse 29). In addition to some Quranic verses above, the basis in operating Islamic banks is Law No. 21 (2008) concerning Islamic Banking, Government Regulation No. 72 (1992) concerning banks based on the profit sharing principle, among others, regulates provisions concerning the process of establishing a commercial bank without interest. According to Article 28 and 29 of the Decree of the Board of Directors of Bank Indonesia No. 32/34/KEP/DIR (dated May 12, 1999), concerning banks based on revenue sharing principles, regulates several business activities that can be carried out by Islamic banks.

Other regulations specifically regulating contracts in business activities based on Shariah principles are Bank Indonesia Regulation No. 10/16/PBI/2008 concerning amendments to Bank Indonesia Regulation No. 9/19/PBI/2007 concerning application of Shariah principles in funds collection and activities distribution of funds and Islamic bank services. Another regulation that provides the basis for the operation and settlement of Islamic banking disputes is Law No. 3 (2006) concerning amendments to Law No. 7 (1989) concerning religious courts. In law, there is an understanding of Islamic economics and the absolute competence of the religious courts in resolving Islamic economic disputes. Act Law No. 3 (2006) was amended by Law No. 50 (2009) concerning the second amendment to Law No. 7 (1989) concerning religious courts.

In the legal relationship between the bank and the customer begins with the agreement that applies to them. The contract is a relationship between *ijab* (offer) and *qabul* (acceptance) which is justified by *Syara'* (Islamic law) which has a legal effect on the object (Dewi, 2005). The implementation of the contract was originally intended so that the objectives of the parties could be realized, but in its implementation, not all contracts were going well.

The legal relationship between the bank and the customer arises because of savings, financing, and investment. Problem financing is one of the five big problems facing national banking. Problematic financing is a credit that is in the classification of doubtful and non-performing loans. Based on Article 1 No. 25 of the Islamic Banking Law, financing is the provision of funds or claims that involves:

a. Profit-sharing transactions in the form of *muḍarabah* and *musyarakah*;
b. Leasing transactions in the form of *ijarah* or leasing in the form of *ijarah muntahiya bittamlik*;
c. Buying and selling transactions in the form of *murabahah*, *salam* and *istishna'* receivables;
d. Loan and loan transactions in the form of *qarḍ* receivables; and
e. Leasing transactions in the form of *ijarah* for multi-service transactions based on an agreement or agreement between an Islamic Bank and/or Shariah window Bank and other parties that require parties to be funded and/or given fund facilities to return these funds after a certain period in exchange for *ujrah* (fee), without compensation, or revenue share.

In the event of problematic financing, the bank maintains its liquidity by trying to resolve the problems it faces. Based on the principle of the contract, the *pacta sunt servanda* (agreements must be kept) principle can be applied, which means that the parties' agreement is legally binding on the parties as law. The power to resolve Islamic banking issues or disputes depends on the parties. However, it must remain in the corridors of Shariah, that is, regarding the Islamic law provisions of the Quran, Hadith and *Ijtihad*. The main principles that must be truly understood and considered in dealing with Shariah banking cases and the general Islamic law economic issues in the process of resolving these cases should not conflict with the principles of Islamic law. This is a basic principle for handling and resolving Islamic banking cases in religious courts, as Islamic banking confirms the provisions of Article 1, paragraph 7. Article 2 of the Shariah Act carries out its business activities solely based on Shariah principles.

3. Research Methodology

This study uses secondary data, namely data obtained from library research such as the Quran, Hadith, *Fatwa*, Islamic banking laws, regulations relating to the resolution of disputes in Islamic banking, papers and books. Data collection techniques in this paper are literature studies and case studies. A literature study is carried out by studying the laws of Islamic banking, books, papers, journals relating to the problem study. Case studies conducted by looking at the facts that occur in the field. In this paper is a case about Islamic banking disputes in Indonesia and Malaysia. This research was conducted to record social facts in the economic field, especially in Islamic banking practices.

Existing data and legal materials related to the resolution of Islamic banking disputes are described, compared and analyzed completely and in detail based on the research objectives. This is done to facilitate the interpretation or to find the meaning of existing data and make it easier to formulate conclusions to answer the purpose of writing. Data analysis was carried out in the form of a qualitative analysis describing the mechanism of Islamic banking dispute resolution in Indonesia and Malaysia which were oriented to the principles of justice, legal certainty and benefits of the community.

4. Discussion

Regarding the capacity of the judiciary, as stated in Law No. 14 (1970), Law No. 35 (1999), Law No. 4 (2004), Law No. 48 (2009) on the jurisdiction, the judicial environment in Indonesia is divided into general justice (PU); religious courts (PA); military justice; and the state administrative court (PTUN). Each judicial environment has jurisdictions based on its laws. If the boundaries of these jurisdictions are violated, the claim will be flawed and the court will declare that he has no power to rule. Also, there is a constitutional court that has the authority to adjudicate at the first and last levels to examine the Law on the 1945 Constitution of the Republic of Indonesia. One of its products on August 29, 2013, was decision No. 93/PUU-X/2012. The decision was related to the review of Law No. 21 (2008) concerning Islamic banking, particularly in Article 55 paragraphs (2) and (3) in the field of dispute resolution on Islamic banking. Through the decision, the constitutional court returned competence to the religious courts.

In the article on the settlement of contractual disputes through Islamic banking, there are stages of settlement: First, efforts are sought by deliberation and consensus. Second, efforts are resolved through National Shariah Arbitration Board (Basyarnas). After the enactment of Law No. 50 (2009), staff of the legal department, when making a contract directs their resolution through the religious courts, but in its implementation, there are still obstacles including the readiness in the religious courts and Basyarnas. In the event the religious court is not ready, the recommendation of the National Shariah Council (DSN) for dispute resolution can be done through Basyarnas. This is based on the National Shariah Board *Fatwa* No. 47/DSN-MUI/II/2005 concerning the settlement of *murabahah* receivables for poor customers. In the case of dispute resolution through the religious courts there are still obstacles related to the system, which include: stages, mechanisms or flow and special procedural law to be applied, dispute resolution can be done through Basyarnas.

Dispute resolution through Basyarnas has not yet been regulated in separate statutory regulations. During this time the parties can agree regarding the Indonesian Ulama Council (MUI) Decree No. 09/MUI/ XII/2003 dated December 24, 2003, stipulated among others the change in the name of Bamui/Badan Arbitrase Muamalat (Muamalat Arbitration Board) to Basyarnas and to change the form of the legal entity which was originally a foundation into a "body" that was under the MUI and was a tool of the MUI organization.

Dispute resolution through Basyarnas is based on Law Number 30 (1999) concerning alternative dispute resolution (ADR). The settlement model is through arbitration, mediation, negotiation, and reconciliation. Problems with the legal system are needed after the enactment of Law No. 3 (2006) related to the contents of Article 3 and Article 11 of Law No. 30 (1999).

Article 3 of Law No. 30 (1999) contains: “The district court has no authority to adjudicate disputes of parties who have been bound in an arbitration agreement”. Article 11 paragraph 1 and 2 of Law No. 30 (1999) contains:

Article (1): The existence of a written arbitration agreement negates the right of the parties to submit a dispute resolution or dissent contained in the agreement to the district court.

Article (2): The district court must refuse and will not intervene in a dispute that has been determined through arbitration, except in certain cases stipulated in this law.

In addition to referring to the MUI *fatwa*, Islamic banking dispute resolution can refer to the dispute resolution guidelines that have been made by Basyarnas using analytical interpretation of Law No. 30 (1999). Understanding the district court in terms of Law No. 30 (1999) can be analogous to the religious court after the enactment of Law No. 3 (2006).

If in the implementation of the arbitration award the parties do not comply with the contents of the decision because of fraud, dishonesty and fraud from one of the parties, the party that feels disadvantaged can file a cancellation of the arbitration award to Basyarnas. However, if one party does not want to comply with the contents of the arbitration award and is detrimental to the other party, the effort that can be made is to apply to the application for the execution of the decision to the religious court.

The process of resolving Islamic banking disputes as regulated in Article 55 paragraph 1, paragraph 2, and paragraph 3 of the Islamic banking law has given duties and authorities to the courts in the religious court environment. This matter is also regulated further in Article 49 of Law Number 3 (2006) concerning religious courts in which dispute resolution is not only limited to Islamic banking but also in other Islamic economics.

According to the Constitutional Court, systematically, the choice of a legal forum for dispute resolution by the contract is the second choice if the parties do not agree to settle the dispute through the religious court. Thus the choice of a legal forum to resolve Islamic banking disputes must be clearly stated in the contract (agreement). The parties must agree to choose one of the legal forums in dispute resolution if the parties do not wish to resolve it through the religious court. The problem arises when there is no clearly stated legal forum in the contract. The issue of the unclear choice of legal forum was not only experienced by the petitioner, but several similar cases occurred until finally a legal conflict arose and there were several decisions at the arbitration or court level that tried the same case. A contract (agreement) is an act for those who make it according to the provisions of Article 1338 of the Civil Code, a contract must not conflict with the law, moreover the law which has established the absolute power of a binding judicial body the parties to the agreement. Therefore, clarity in the preparation of the agreement is a must. The parties should clearly state one of the chosen legal forums in the event of a dispute. The law regulates normatively by providing examples of legal forums that can be chosen by the parties making the agreement.

In addition, according to the constitutional court, the choice of a legal forum as stipulated in the elucidation of Article 55 paragraph (2) of the Islamic banking law in some concrete cases has opened the space for a settlement forum choice which also has raised the issue of constitutionality which in turn can lead to uncertainty laws that can cause harm not only to customers but also to Islamic banking. The choice of forum for resolving disputes in Islamic banking as explained in the elucidation of Article 55 Paragraph (2) of the *a quo law* (that law) will eventually lead to overlapping authority to adjudicate because there are two courts given the authority to settle Islamic banking disputes whereas in other Acts (law on religious courts) it is explicitly stated that religious courts are given the authority to settle Islamic banking disputes including Islamic economic disputes.

Referring to the disputes experienced by the petitioner and practices in solving Islamic economic disputes as described above, according to the constitutional court, the law should provide certainty for customers and also Islamic banks in solving Islamic banking disputes. If certainty in the settlement of Islamic banking disputes cannot be realized by an institution that is truly competent in handling Islamic banking disputes, then, in the end, the legal certainty as guaranteed in Article 28D paragraph (1) of the 1945 Constitution will also never be realized.

The constitutional court considered that the provisions in the elucidation of Article 55 paragraph (2) of *a quo law* (that law) did not provide legal certainty. Based on this fact, even though the court does not hear concrete cases, there is sufficient evidence that the provisions of the elucidation of a quo article have created legal uncertainty and the loss of the customer's constitutional right to obtain fair legal certainty in the settlement of Islamic banking disputes.

The existence of the decision of the constitutional court illustrates that the dispute of Islamic banking requires the synergy of all banking elements starting from Bank Indonesia (BI), Financial Services Authority (OJK), Islamic banks, Islamic Window Banks and the public as users of Islamic banking services.

Similar to other Commonwealth countries in the world, Malaysia legal system inherits the common law-based legal system left over from the age of empires and was later developed to meet the customs and needs of local people. The common law tradition will naturally use litigation as the main channel for resolving disputes. The court handles the disputes submitted to the judges and resolves them through litigation procedures, which are complex and subject to procedural requirements and litigation procedures, which are time-consuming and costly. Over time and long-term practice, litigation is seen and accepted as the main dispute resolution procedure mentioned by the parties to the dispute. In this case, this is considered necessary to obtain a settlement. However, litigation is not the only mechanism that can be used to resolve financial disputes. Other dispute resolution mechanisms can also be invoked. Such other dispute resolution mechanism may be better suited to meet the needs of the parties. In addition to litigation procedures, most other dispute resolution mechanism are now referred to as alternative dispute resolution (ADR) (Mohd Zain and Engku Ali, 2016).

The dispute resolution framework for addressing Islamic financial disputes in Malaysia has taken the lead in the modern world. Considering the different pace of industry development in different jurisdictions around the world, the main phase of the Islamic finance industry in Malaysia and the ongoing regulatory and legal reforms to improve the provision of Islamic financial services are enviable. The current institutional framework for resolving Islamic financial disputes is encouraging, but the extent to which Islamic financial practitioners and financial institutions have used the framework for further analysis (Oseni and Ahmad, 2011).

The current dispute resolution procedures commonly used in the Islamic financial industry include court decisions, mediation, and adjudication by the Malaysia Mediation Council (MMC), Shariah Advisory Council of the Central Bank of Malaysia (SAC), Financial Mediation Authority (FMB), Kuala Lumpur Regional Centre for Arbitration (KLRCA), Securities Industry Dispute Resolution Centre (SIDREC), Small Debt Resolution Committee (SDRC) (Engku Ali et al., 2015).

MMC's services include mediation services, assistance and advice, and if one party expresses interest, how to get the other party to agree to mediation and provide mediation training for those interested in becoming mediators. These efforts of the Bar Association were consolidated when the mediation practice instructions were issued in August 2010 (Oseni and Ahmad, 2011).

As the main advisory body for top Islamic banking financial services, SAC plays an important role in dispute resolution and Islamic legal dispute avoidance. To put it simply, when a court or arbitral tribunal refers to the Shariah question, the SAC determines Islamic law on this issue and issues a ruling that is considered in the final judgment or ruling of the court or arbitral tribunal respectively (Oseni and Ahmad, 2011).

Established by the Central Bank of Malaysia, FMB operates as an independent agency that enforces dispute resolution procedures through mediation and rulings between its members and its financial services providers. The primary purpose of establishing FMB is to correct any discrepancies related to transactions between customers or the general public and their listed members (financial service providers) (Engku Ali et al., 2015).

The Kuala Lumpur Regional Arbitration Center (KLRCA) is a dispute resolution body established under the auspices of the Asian-African Legal Consultation Organization (AALCO) in 1978. The mediation process is done entirely privately and confidentially. Although KLCMC has performed well for many years since its inception, it has not been so successful in mediating Islamic financial disputes; some of the Islamic financial disputes mentioned have been properly mediated, but mediation has failed and the parties have returned to court for normal litigation (Engku Ali et al., 2015).

The Securities Industry Dispute Resolution Centre (SIDREC) is like the FMB, the latter is used for banking and takaful disputes, and the former is specifically intended for disputes involving investors and capital market intermediaries registered as its members (Engku Ali et al., 2015).

Recent legal disputes involve the constitutionality of the powers and functions of the SAC, which is related to the court's responsibility to determine all issues before it. The constitutionality of power in Tan Sri Khalid bin Ibrahim vs Bank Islam Malaysia Bhd, SAC was challenged. Undoubtedly, SAC has helped stabilize the Islamic financial industry in Malaysia, but when Shariah is in direct contact with the civil law system based on English common law, there must be some incompatibility factors and procedure. Although the matter is currently being tried in federal courts, one might think that the way to get out of this legal dilemma is to combine litigation with other specialized forms of dispute resolution, the former being used as the last resort in the continuous process of dispute resolution procedures (Oseni et al., 2013).

The negative impact of the judicial precedent prevailing in Malaysian common law jurisdictions is now reflected in the Islamic finance industry. Following the precedent principle, higher court decisions are binding on lower courts. Lower courts must consider previous high court decisions when making decisions. If a High Court judge is allowed to hear and judge an appeal in the *Muamalat* court without the necessary guidance of an expert, then the appeal court's decision will be binding in subsequent lower court cases. This is a legal risk for Islamic financial transactions, as the court can, through its ruling, reorganize the commonly known Islamic financial product (Oseni and Ahmad, 2011).

Therefore, financial transaction issues can be better addressed through a friendly dispute resolution process. But with the legal transfer of British common law to Malaysia as part of the colonial heritage, Islamic financial disputes are civil courts. As evidenced by this research and other relevant literature, Islamic financial litigation does not conform to the essence of the Islamic financial services industry. This choice of dispute resolution process was made during the contract phase (Oseni et al., 2013).

4.1 The Role of Courts in the Settlement of Islamic Banking Disputes in Efforts to Resolve Disputes to Protect Economic and Social Rights

Since the early days of Islam, the theory and practice of dispute resolution in Islamic law have developed. It begins with some legal texts in the Quran that are proved by the Prophet (p.b.u.h). Islamic Dispute Resolution (IDR) refers only to any procedure or mechanism that promotes friendly settlement of disputes, including court decisions (*qaḍā*), whose procedures and final results are consistent with the Shariah principle (Azad, 1987). In Islamic law, IDR is not considered as an alternative to the court, but a complementary process to facilitate the dispute resolution process (Oseni, 2014). The common process of dispute resolution in Islamic law according to (Rashid, 2004):

1) *Nasihah* (counseling or advisory services)
2) *Sulh* (negotiation, mediation, compromise of action)
3) *Tahkim* (Arbitration)
4) *Med-Arb* (A process that begins with meditation and ends in arbitration)
5) *Muhtasib* (Ombudsman)
6) *Wali al-mazalim* (Chancellor or Ombudsman Judge)
7) *Fatwa of Mufti* (Expert Determination)
8) *Med-Ex* (A combination of mediation and expert determination) and
9) *Qada* (adjudication)

Although most of the dispute resolution procedures are related to the majority of contractual disputes, not all disputes are related to Islamic financial disputes. For example, the most common processes in Malaysia are *Sulh and Tahkim,* the SAC of the Central Bank of Malaysia has played this important role. The SAC was accorded the status of the sole authoritative body on Shariah matters pertaining to Islamic banking, takaful and Islamic finance. While the rulings of the SAC shall prevail over any contradictory ruling given by a Shariah body or committee constituted in Malaysia, the court and arbitrator are also required to refer to the rulings of the SAC for any proceedings relating to Islamic financial business, and such rulings shall be binding (BNM, 2020).

The concept of *Sulh* represents the most important method of IDR (Engku Ali et al., 2015). *Sulh* can be called a hybrid approach to the dispute resolution (Hak et al., 2013). In addition to *Sulh*, Islamic arbitration procedures or *Tahkim* are more suitable for Islamic financial disputes (Engku Ali et al., 2015). *Tahkim* occurs when disputing parties agree to appoint a qualified person (arbitrator) to resolve their dispute with reference to Islamic law through a formal process (Hak et al., 2013).

In Indonesia, there are two Islamic Shariah Bank Dispute Resolution Forums, namely, litigation forums brought by the judiciary in the religious court environment, and non-litigation forums consisting of multiple choices: deliberation, bank mediation, and national Shariah arbitration body. The deliberation or negotiation between the parties to the dispute is the first way the Islamic banking community has always taken the solution. This deliberation is an intern between the bank and the client and does not involve an external third party. Both sides tried to reach an agreement through negotiations to solve the problem. If it cannot be resolved through deliberation, the next step is mediation. According to Article 6 of the Supreme Court Regulation No. 02/2003, the mediation is to resolve the dispute through a negotiation process of the parties assisted by the mediator. As can be seen from this definition, mediation is an informal process designed to enable parties to a dispute to discuss differences privately with the help of neutral and objective third parties (Ridwan and Ridwan, 2017). The next step is through Basyarnas, a permanent body established by the Indonesian Ulama Council to address the possibility of *muamalah* disputes arising in trade, industry, finance and service relations. Basyarnas is a free, autonomous and independent institution, not interfered with and not influenced by institutions of power and other parties. Basyarnas has the authority to fairly and quickly settle *muamalah* (civil) disputes that arise in the fields of trade, finance, industry, Islamic financial services (Rinanda et al., 2018).

In addition to the above efforts, the parties can also choose a litigation (court) path to resolve Islamic banking disputes. So the court is the last resort as a case breaker, namely the religious court. According to Article 49(i) of Law No. 3 (2006), the religious court has the responsibility and power to review and resolve the first-level cases among customers in the field of Islamic economics, including: Islamic bank, Islamic microfinance institutions, Islamic insurance (takaful), Islamic reinsurance, Islamic mutual funds, Islamic bonds (sukuk) and Islamic interim securities, Islamic securities, Islamic financing, Islamic pawn shops, Islamic financial institution pension funds and Islamic commercial pension funds. Constitutional Court No. 93 / PUU-X/2012 reinforces this power and strengthens the religious court as an institution with the power to receive, review and determine Islamic law economic cases.

These authorities are part of the efforts to protect the economic and social rights of the community. The Constitution of 1945 recognized and guaranteed human rights, including economic and social rights. One of the court institutions that functions to protect such rights is the constitutional court. If citizens, both individuals, and communities or legal entities that consider their constitutional rights impaired due to the enactment of the law, they can submit a test of the relevant law to the constitutional court. Specifically for individual citizens and the customary law community unit, the material testing mechanism also intended to guarantee the protection of human rights guaranteed by the 1945 Constitution (Isra, n.d.). As stated above, constitutional court decision No. 93/PUU-X/2012 can be used as evidence to test material testing conducted by the constitutional court to protect and promote economic and social rights.

For individuals and communities living in poverty, reshaping their lack of education, health care, housing or clean water is not a failure of government policy, but deprivation of their rights. When these rights are legally recognized, coupled with legal knowledge and empowerment programs, and supported by a vibrant civil society, they are an important force for change (Khan and Petrasek, n.d.).

5. Conclusion and Recommendation

Due to the complexity and scope of the work, disputes are common in Islamic banking. Therefore, the application of dispute resolution cannot be avoided. The dispute resolution mechanism in Indonesia and Malaysia have the same basic principles, which are carried out through litigation and alternative dispute resolution (eg. *Sulh and Tahkim*). Interestingly in Indonesia is that the emergence of a dispute between the client and an Islamic bank triggered the constitutional court to cancel Article 55, paragraph 2, of the Islamic Banking Act No. 21 (2008). The main reason given by the constitutional court is that it has no legal standing and is therefore considered incompatible with the Constitution 1945 because it is the main constitution of the Republic of Indonesia. Also, it is equally important that the article is considered to violate the socio-economic rights of Islamic banking clients.

Cancellation of the article, making the religious court the only court institution entitled to adjudicate disputes in Islamic banking in Indonesia. As a result, it has led to the number of cases in religious courts exceeding the number of judges. The broad scope of the Islamic economy will certainly cause religious court judges to focus on resolving Islamic economic disputes. Therefore, a special court is needed to handle Islamic economic matters including Islamic banking with judges who have special qualifications in the related fields. It is intended that the court institution can adjudicate more effectively, efficiently, professionally and constitutionally.

Acknowledgement
The paper has been presented at the International Conference on Islamic Social Finance: Pandemic Crisis and Possible Solutions (Online) organized by the IIUM Institute of Islamic Banking and Finance on 29th – 30th September 2020. We thank the reviewers and the Journal Editor for the constructive comments for further improvement of the paper.

References

Engku Ali, E. R. A., Oseni, U. A., Adeyemi, A. A., & Mohd Zain, N. R. (2015). Dispute resolution mechanisms in the Islamic finance industry in malaysia: towards a legal framework. *Al Shajarah* (Special Issue Islamic Banking and Finance), 19-40.

Azad, G. M. (1987). *Judicial system of Islam*. Islamic Research Institute, International Islamic University: Pakistan.

BNM. (2020). Shariah Advisory Council Bank Negara Malaysia. Central Bank of Malaysia. Retrieved December 14, 2020, retrieved from https://www.bnm.gov.my/index.php?ch=en_about&pg=en_thebank&ac=439&lang=en

Dewi, G. (2005). *Hukum perikatan Islam di Indonesia*. Jakarta: Prenada Media.

Hak, N. A., Ahmad, S., & Oseni, U. A. (2013). *Alternative dispute resolution in Islam*. Kuala Lumpur: IIUM Press.

Isra, S. (n.d.). Peran mahkamah konstitusi dalam penguatan hak asasi manusia di Indonesia. Retrieved August 31, 2019, from https://www.saldiisra.web.id/index.php/buku-jurnal/jurnal/19-jurnalnasional/634-peran-mahkamah-konstitusi-dalam-penguatan-hak-asasi-manusia-di-indonesia1.html

Khan, I., & Petrasek, D. (n.d.). Beyond the courts – protecting economic and social rights | OpenGlobalRights. Retrieved August 31, 2019, from https://www.openglobalrights.org/beyond-courts-protecting-economic-and-social-rights/

Mohd Zain., N. R., & Engku Ali, E. R. A. (2016). The introduction of the financial ombudsman scheme as an alternative to dispute resolution in the Islamic financial. *Al-Shajarah* (Special Issue Islamic Banking and Finance), *21*(3), 243–260.

Munib, A. (2018). Hukum Islam dan muamalah. *Jurnal Al-Ulum*, *5*(1), 72–80.

Oseni, U. A. (2014). Dispute management in Islamic financial institutions: a case study of near sukuk defaults. *Journal of International Trade Law and Policy*, *13*(3), 198–214.

Oseni, U. A., Adeyemi, A. A., & Mohd Zain, N. R. (2013). Customers' perceptions on the dispute resolution clauses in Islamic finance contracts in Malaysia, *2013*(Act 759), 1–21.

Oseni, U. A., & Ahmad, A. U. F. (2011). Dispute resolution In islamic finance : a case analysis of Malaysia. 8th International Conference on Islamic Economics and Finance. Center for Islamic Economics and Finance, Qatar Faculty of Islamic Studies, Qatar Foundation.

Rashid, S. K. (2004). Alternative dispute resolution in the context of Islamic law. *The Vindobona Journal of International Commercial Law and Arbitration*, *8*(1), 95–118.

Ridwan, M., & Ridwan, M. (2017). Penyelesaian sengketa perbankan Syariah di Indonesia. *Malia*, *1*, 45–56.

Rinanda, R. F., Ria, W. R., & KW, Y. (2018). Penyelesaian sengketa bisnis Syariah melalui Badan Arbitrase Syariah Nasional (Basyarnas). *Pactum Law Journal*, *1*(2), 145–154.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 138-145
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Examining the Firm-Specific Factors Influencing Systematic Risk of Transportation Firms in Malaysia and Singapore

Vilayphone Vongphachanh*, Khairunisah Ibrahim

Department of Finance, Kulliyyah of Economics and Management Sciences, International Islamic University Malaysia

Corresponding author: na-chang@hotmail.com

Abstract

The objective of this study is to examine the effect of firm-specific variables on systematic risk in the transportation industry in Malaysia and Singapore for 20 years from 1997 to 2016. To determine the systematic risk, this study employs panel data analysis of Fixed Effect Model (FEM), Pooled Ordinary Least Square (POLS), and Random Effect Model (REM). Overall findings of both countries showed that financial leverage, profitability, and firm growth are insignificant to systematic risk. However, Malaysia shows liquidity significantly and positively associated with systematic risk. Meanwhile, Singapore indicates a positive relationship with firm size. Moreover, by examining the impact of the financial crisis (2008) on systematic risk, this study found that the presence of the financial crisis does not influence the behaviour of systematic risk in the transportation industry in Malaysia and Singapore. The findings of this study contribute to the finance literature which may help to increase the current understanding about the nature of systematic risk of the firms, including the Shariah-compliant transportation firms in Malaysia. A good perception of the sources of risk may assist policymakers as well as firm managers to obtain new ideas against external issues such as systematic risk, and this may help firms to increase profitability and prevent them from a loss or bankruptcy cost. Moreover, the additional information about the financial crisis and systematic risk may help firm managers to be more prepared to handle systematic risk in a normal as well as during crisis periods.

Keywords: systematic risk, transportation, firm-specific factors, Shariah-compliant

1. Introduction

Total risk is a combination of diversifiable and non-diversifiable risk. The diversifiable risk is the specific risk to firms which can be eliminated through efficient diversification, also known as unsystematic risk. The non-diversifiable risk or systematic risk is the market related risk which cannot be avoided or reduced through efficient diversification, and this type of risk affects the market as a whole (Pham and Vo, 2019). It can be said that unsystematic risk results from internal factors within the organization itself that affects the only particular organization, whereas systematic risk results from the external factors which are known as macro variables or market forces for example, inflation, unemployment, exchange rate volatility, interest rate risk and the current pandemic crisis of Covid-19. Therefore, the external factors which cannot be avoided such as systematic risk are the most concerned for firm managers and investors (Charles, 2007, Nizam et al., 2020).

Due to the nature of systematic risk which cannot be avoided or minimized through diversification, it plays important role in determining the rate of return of firms. Therefore, investors and managers are more concerned about systematic risk rather than unsystematic risk (Pham and Vo, 2019). Previously, some studies have been focusing on developing models to estimate the systematic risk (Bollerslev and Zhang, 2003; Chen, 1991; Milionis, 2011; Chhapra et al., 2020). These models however can only demonstrate a relationship

Article history:
Received 20 October 2020
Revised 31 October 2020
Revised 3 November 2020
Revised 8 November 2020
Accepted 9 November 2020

between systematic risk and expected return on investment hence cannot identify the main factors that influence the behaviour of systematic risk.

Meanwhile, several studies examined the effect of firm-specific variables on systematic risk in various industries and countries (e.g. Borde, 1998; Eldomiaty, 2009; Gu and Kim, 2002; Rowe and Kim, 2010; Alaghi, 2013; Ibrahim and Haron, 2016; Nizam et al., 2020; Frutig and Das, 2020). The findings of these studies provided a better understanding of systematic risk by examining the main factors affecting systematic risk. For example, Iqbal and Shah (2012) found that liquidity and operating efficiency are significantly and negatively related to systematic risk while profitability and firm size are positively related. However, they found leverage and firm growth are not significant in the non-financial firms listed in the Karachi stock exchange.

Similarly, Borde (1998) revealed three main factors such as liquidity, growth, and profitability influence the behaviour of systematic risk in different food businesses whereas leverage is reported as insignificant. Furthermore, Rowe and Kim (2010) showed at least two variables that can determine systematic risk in the non-Shariah compliant industry which are leverage and firm size but profitability, liquidity, and growth are not insignificant. Aruna and Warokka (2013) also used some firm-specific variables to determine systematic risk in an emerging market and their results indicated an insignificant influence between accounting variables and systematic risk. That means, not all accounting variables can influence systematic risk. Based on the past studies of systematic risk, it can be concluded that the previous studies provided mixed results on the main factors affecting systematic risk. This may be due to the isolation of industries and countries. Meantime, there is a lack of studies examining the source of systematic risk in a particular industry in different countries and performing a comparison especially in the transportation industry.

Transportation industry is a very important sector for the economic development of any country because the transportation firms provide many services to the population. All imported and exported goods are in need of transportation whether through the land, airline, or marine services. Moreover, many people are traveling by using public transportation as well as traveling to other countries by air and ships. Therefore, the profit of transportation firms are relatively high especially when the management of firms is good (Lu and Chen, 2015). This study examines the effect of firm-specific variables on systematic risk in the transportation industry in Malaysia and Singapore for a period of 20 years from 1997 until 2016. Malaysia is the neighbouring country of Singapore separated only by the Tebrau Strait. Both are members of the ASEAN-5 with a significant economic contribution in the Southeast Asian region. The overview of the economic outlook for Southeast Asia (OECD, 2019) illustrates the real GDP growth of Malaysia and Singapore is 4.8 % and 2.9%, respectively, and the expectation of GDP growth from 2019 to 2023 is about 4.6 % and 2.6 % respectively. Malaysia however is a developing country while Singapore is a developed country, therefore the factors influencing the systematic risk of firms in each country may differ following the different economic structure between the two countries (Wongbangpo and Sharma, 2002; Alaghi, 2013; Ibrahim and Haron, 2016; Nizam et al., 2020). Based on this backdrop, the objective of this study is to make a comparison of firm-specific factors influencing the behaviour of systematic risk between the transportation firms of these two countries.

2. Data and Methodology

This study employed secondary data sourced from Thomson DataStream on firms classified as transportation firms listed in the Bursa Malaysia and Singapore Stock Exchange. Based on this classification, the panel data set consists of 63 transportation listed firms in both Malaysia and Singapore, for 20 years from 1997 to 2016. Out of the 63 firms, 31firms are from Malaysia and 32 firms are from Singapore. Following Haron (2014), only firms that have been listed in the stock exchange for the past three years (from 2016) are included in the sample. Most of the transportation firms in Malaysia are Shariah compliant firms based on the Securities Commission of Malaysia Shariah compliant listing (Securities Commission, 2016) while the Singapore firms are not ascertained due to the absence of Shariah compliant list for Singapore listed firms. This study examines systematic risk with a set of firm-specific variables in the transportation industry, which are financial leverage, liquidity, profitability, operating efficiency, firm growth, and firm size, together with the global financial crisis of 2008. The variables' measurements are provided in Table 1.

The panel regression model of this study is depicted below.

$$Systematic\ Risk_{i,t} = a_0 + a_1 Financial\ leverage\ _{i,t} + a_2 Liquidity_{i,t} + a_3 Profitability_{i,t} + a_4 Firm\ size_{i,t} + a_5 Firm\ growth_{i,t} + a_6 Operating\ efficiency_{i,t} + a_7 Financial\ crisis\ 2008_t + \varepsilon_{i,t}$$

Table 1: The Measurement of Independent Variables

Variable	Measurement	References
Systematic Risk	Beta	Nizam et al. (2020)
Liquidity	current asset/current liabilities	Haron (2018)
Profitability	Net income /Total asset	Alaghi. (2013)
Operating Efficiency	Total revenew/Total asset	Alaghi. (2013)
Firm Growth	Annual Percentage Change in earnings	Nizam et al. (2020)
Firm Size	Natural logarithm of total asset	Nizam et al. (2020)
Financial Crisis 2008	Dummy 1 for crisis, 0 otherwise	Haron et al. (2020)

This study performed the panel data analysis using Stata 12 to explore the main factors influencing systematic risk of the firms. Three panel data models are employed, the Fixed Effect Model (FEM), Pooled Ordinary Least Square (POSL) and Random effect model (REM). The procedure of selecting the most appropriate model for this study is based on the three statistical tests, which are the Chow Test, Breusch and Pagan Lagrangian Multiplier Test (BP-LM), and Hausman Test (see, for e.g., Haron, 2018). Moreover, this study performed the test on multicollinearity, auto-correlated, and heteroskedastic after obtaining the most appropriate model and solve the related problems by employing the robust standard error. There is no issue with multicollinearity since the correlations between independent variables are less than 0.85 (Aslam and Haron, 2020) (refer Table 2 and 3 for details). This study utilized the unbalanced panel data due to the different listing years of the transportation firms in the sample. The summary of the three tests of this study is provided in Table 5 and 6.

Table 2: Correlations between Independent Variables of Malaysian Transportation

Variable	X1	X2	X3	X4	X5	X6
X1	1					
X2	-0.3194	1				
X3	-0.3622	0.2529	1			
X4	0.1155	0.0276	0.145	1		
X5	0.0421	0.0271	0.0319	-0.0071	1	
X6	-0.3269	-0.0346	0.0039	-0.5998	0.0071	1

Notes: X1 (Financial leverage), X2 (Profitability), X3 (Liquidity), X4 (Firm size), X5 (Firm growth), X6 (Operating efficiency)

Table 3: Correlations between Independent Variables of Singaporean Transportation

Variable	X1	X2	X3	X4	X5	X6
X1	1					
X2	-0.0987	1				
X3	-0.2972	-0.0001	1			
X4	0.2423	-0.2128	0.0498	1		
X5	0.0171	0.0083	0.2001	-0.0045	1	
X6	-0.2528	-0.1384	0.1069	-0.2095	-0.0214	1

Notes: X1 (Financial leverage), X2 (Profitability), X3 (Liquidity), X4 (Firm size), X5 (Firm growth), X6 (Operating efficiency)

Table 4 and 5 show the descriptive information of Beta and six independent variables, the mean value of Beta in non-financial firms of Malaysian and Singaporean transportation are 0.895 and 0.967, respectively. These values are less than one which means Malaysian and Singaporean transportation firms are less risky than the market because the mean value of market beta is always equal to one. Interestingly, the systematic risk of transportation firms in Malaysia (Shariah compliant classified) is relatively lower compared to its Singapore counterpart (non-Shariah compliant classified) supporting Farooq and Alahkam (2016) who reported a different risk level between Shariah and non-Shariah compliant based on firms from the MENA region.

Table 4: Descriptive of Malaysian Transportation

Variable	mean	sd	Skewness	kurtosis	max	min
Beta	0.895	0.408	-3.616	16.127	2.076	-0.992
Financial leverage	30.459	26.976	4.964	58.729	367.080	0.030
Profitability	2.412	2.319	3.241	18.975	21.170	0.020
Liquidity	3.849	10.775	-3.648	28.427	42.880	-91.740
Firm size	13.075	1.480	0.363	3.243	17.842	8.899
Firm growth	0.116	7.925	-5.801	145.569	73.841	-120.015
Operating efficiency	0.575	0.450	1.268	5.343	3.130	0.010

Table 5: Descriptive of Singaporean Transportation

Variable	mean	sd	Skewness	kurtosis	max	min
Beta	0.967	0.156	-5.162	30.505	1.323	-0.039
Financial leverage	27.013	17.677	0.332	2.430	85.140	0.010
Profitability	2.524	4.392	6.035	45.687	45.430	0.070
Liquidity	4.791	13.107	0.371	13.673	89.180	-68.170
Firm size	12.738	1.561	0.106	2.971	16.958	8.329
Firm growth	-0.018	6.702	-2.462	94.291	54.801	-88.367
Operating efficiency	0.681	0.552	1.665	7.608	3.490	0.010

Table 6: Results for Three Tests of Panel Data Analysis in Malaysian Transportation Firms

Chow Test	Hausman Test	BP-LM test
Do not reject H_0	Do not Reject H_0	Do not reject H_0
FEM better than Pooled OLS	REM better than FEM	REM better than Pooled OLS
F-state = 0.38**	Chi2 = 10.01	chibar2 = 5.17**

Table 7: Results for Three Tests of Panel Data Analysis in Singaporean Transportation Firms

Chow Test	Hausman Test	BP-LM test
Reject H_0	Do not reject H_0	Reject H_0
Pooled OLS better than FEM	REM better than FEM	Pooled OLS better than REM
F-state = 1.40	Chi2 = 4.86	chibar2 = 0

Based on Table 6 and Table 7, the results of the tests shown that REM is the most appropriate model to estimate the parameters of interest in the Malaysian transportation firms while the POLS is the best estimator for Singaporean transportation firms. These two models are used to explore the sources of systematic risk of the firms in the respective countries. The detailed findings and discussion are discussed in the following section.

3. Findings and Discussion

Table 8: Regression Results for Malaysian Transportation Firms

Variable	Coefficient	Std. Error	Z-statistics	Prob
Financial leverage	0.0010	0.0007	1.20	0.23
Liquidity	0.0150	0.0071	2.11	0.035
Profitability	0.0003	0.0014	0.21	0.837
Firm size	0.0140	0.0211	0.65	0.518
Firm growth	0.0006	0.0012	0.55	0.585
Operating efficiency	0.0522	0.0569	0.92	0.359
Financial crisis 2008	0.0259	0.0721	0.36	0.719

Table 9: Regression Results for Singaporean Transportation Firms

Variable	Coefficient	Std. Error	T-statistics	Prob
Financial leverage	-0.0006	0.0005	-1.22	0.224
Liquidity	0.0019	0.00080	2.38	0.018
Profitability	0.0006	0.0009	0.64	0.521
Firm size	0.0063	0.0037	1.67	0.095
Firm growth	-0.0009	0.0008	-1.13	0.260
Operating efficiency	0.01260	0.0094	1.34	0.181
Financial crisis 2008	-0.0765	0.0551	-1.39	0.166

Based on Table 8 and Table 9, the analysis showed that liquidity is significantly and positively related to systematic risk of Malaysian transportation firms ($p<0.05$) while the other variables such as financial leverage, profitability, operating efficiency, firm size, and firm growth are not significant. The positive relationship between liquidity and systematic risk supported the second hypothesis of this study and this is in line with previous studies such as Borde (1998), Kim et al. (2007) and Frutig and Das (2020). Frutig and Das stated that the high liquidity of firms will affect the agency cost, that is, the availability of the free cash flow will influence the behaviour of firms' managers to undertake many projects base on their own interest. This may lead to higher agency cost to the firm, hence increasing the level of systematic risk of the firm. Specifically managers of the transportation firms may incline towards taking many possible projects including the negative NPV projects due to the free cash flow position of the firms. This eventually may increase the systematic risk of the firms had the projects are not properly evaluated. Dogru et al. (2020) in their studies concluded that firms with high-free cash flows gain lower returns compared to firms with low-free cash flows, suggesting that acquisitions reduce underinvestment problems but also increase over investment problems. They concluded further that acquisition seems to be an important tool for firms with limited free cash flows, supporting the underinvestment theory, in which a firm with underinvestment problems gains from acquisitions while firm value decreases when the firm encounters overinvestment problems.

Besides Malaysia, firm size ($p<0.10$) and liquidity ($p<0.05$) are reported as significantly and positively influence the behaviour of systematic risk in Singaporean transportation firms. These two variables are considered as the main factors while other variables are not significantly related to systematic risk. The findings supported the second and fourth hypotheses of this study, a positive relationship between firm size and systematic risk is expected, in the line with the previous studies such as Rowe and Kim (2010) and Nguyen et al. (2019). They stated that a rapid expansion of firm size among firms may lead firms to higher competition and eventually market saturation which may cause firms to face loss or bankruptcy cost, thus experience a higher level of systematic risk.

Apart from the firm-specific variables, both firms in Malaysia and Singapore showed insignificant impact of the financial crisis in 2008 on systematic risk. This may due to the nature of the industry itself. Transportation industry is considered as an important industry that provides many services through land, marine and airline. People who are trading, traveling and delivering things need these types of services irrespective of crisis or non-crisis periods. It can be said that generating profit in this industry is quite high than others especially when the management of firms is good (Lu and Chen, 2015). Therefore, the presence of financial crisis in 2008 may not influence the behaviour of systematic risk since firms still remain profitable. Previously, Chee-Wooi and Chyn-Hwa (2010) also found that there is no any significant relationship between financial crisis (2008) and systematic risk in airline industry in East Asia.

Table 10: Summary of the Impact of Firm-Specific Factors on Systematic Risk of Transportation Firms (Malaysia and Singapore)

	Hypotheses	Full sample	
		Malaysia	Singapore
H1	Financial leverage is positively related to systematic risk.	Not supported	Not supported
H2	Liquidity is positively related to systematic risk.	*Supported*	*Supported*
H3	Profitability is negatively related to systematic risk.	Not supported	Not supported
H4	Firm size is positively related to systematic risk	Not supported	*Supported*
H5	Growth is positively related to systematic risk	Not supported	Not supported
H6	Operating efficiency is negatively related to systematic risk.	Not supported	Not supported
H7	The financial crisis in 2008 has a significant influence on systematic risk.	Not supported	Not supported

4. Conclusion

The main purpose of doing investment is to generate as much profit as possible and to be prudent in risk management. To obtain such purpose there is a need for firm managers and investors to recognize the factors which may cause risk on firms. Risk is uncertainty which may involve in any investment, so firm managers and investors should pay more attention and find out the way to deal with risk especially the systematic risk which is undiversified.

Barring its importance, this study focuses on the systematic risk of transportation firms in Malaysia and Singapore by examining the firm-specific factors that may influence such risk and the global financial crisis of 2008. This study provides evidence that, firm size and liquidity played an important role in influencing the systematic risk of the firms. The findings of this study therefore contribute to the finance literature by enlightening the sources of systematic risk among the firms. The study also highlights the difference in systematic risk level of transportation firms between the two countries which are partly contributed by the Shariah compliant status of the firms.

Furthermore, this study also contributed to policymakers as well as firm managers on the important of liquidity policy related to systematic risk of firms in transportation industry, that is, highly liquid firms may face with the agency cost issue which in turn affects systematic risk. Hence, generating an approach to deal with systematic risk, policymakers should be concerned about the level of firms' liquidity.

Besides policymakers, firm managers should ensure that the main specific factors such as liquidity and firm size are managed efficiently to determine systematic risk. Profitability of firms can be maximized if systematic risk is reduced. A good understanding about the sources of systematic risk related to financial crisis not only assist policy makers and firm managers but it also helps investors on the decision making. Investors may have a sound decision on their investment by looking both at technical analysis (price movement) and fundamental information (relationship between specific variables and systematic risk).

This study highlighted the research gap based on previous studies on systematic risk. However, the number of sample firms is limited to 63 as the study focuses only on the transportation firms in Malaysia and Singapore. Future research may expand this study to include other industries across the ASEAN-5 countries and to compare the difference in systematic risk between the Shariah and non-Shariah compliant firms as well. These comparisons of various industries and Shariah listing status may provide a more comprehensive understanding of the risk of the firms. This therefore may facilitate firm managers to implement the appropriate strategies against the external factors brought by the systematic risk.

References

Alaghi, K. (2013). Determinants of systematic risk of the listed companies in the Tehran stock exchange. *Journal of Basic and Applied Scientific Research*, *3*(1), 596–600.

Aruna, D. C., & Warokka, A. (2013). Systematic risk and accounting determinants: a new perspective from an emerging market. *Journal for Global Business Advancement*, *6*(1), 24-37.

Aslam, E., & Haron, R. (2020). The influence of corporate governance on intellectual capital efficiency: evidence from Islamic banks of OIC countries. *Asian Journal of Accounting Research*, *5*(2), 195-208.

Bollerslev, T., & Zhang, B. Y. B. (2003). Measuring and modeling systematic risk in factor pricing models

using high-frequency data. *Journal of Empirical Finance*, *10(5)*, 533–558.
Borde, S. F., Chambliss, K., & Madura, J. (1994). Explaining variation in risk across insurance companies. *Journal of Financial Services Research*, *8*(3), 177–191.
Borde, S. F. (1998). Risk diversity across restaurants: an empirical analysis. *Cornell Hotel and Restaurant Administration Quarterly*, *39*(2), 64-69.
Charles P. Jones. (2007). *Investment analysis and management* (10th ed). NJ: John Wiley & Sons(Asia) Pte Ltd.
Chee-Wooi, H., & Chyn-Hwa, L. (2010). The determinants of systematic risk exposures of the airline industry in East Asia. *World Applied Sciences Journal*, *10*, 91–98.
Chen, N. F. (1991). Financial investment opportunities and the macroeconomy. *The Journal of Finance*, *46*(2), 529-554.
Chhapra, I. U., Zehra, I., Kashif, M., & Rehan, R. (2020). Is bankruptcy risk a systematic risk ? evidence from Pakistan stock exchange. *Journal of Etikonomi*, *19*(1), 51–62.
Dogru, T., Kizildag, M., Ozdemir, O., & Erdogan, A. (2020). Acquisitions and shareholders' returns in restaurant firms: the effects of free cash flow, growth opportunities, and franchising. *International Journal of Hospitality Management*, *84*, 1-9.
Eldomiaty, T. (2009). The fundamental determinants of systematic risk and financial transparency in the DFM General Index. *Journal of Middle Eastern Finance and Economics*, *5*(5), 1450-2889.
Farooq, O., & Alahkam, A. (2016). Performance of Shariah-compliant firm and non-Shariah-compliant firms in the MENA region. Which is better? *Journal of Islamic Accounting and Business Research*, *7*(4), 268-281.
Frutig, B. S., & Das, P. (2020). Does geographic focus reduce systematic risk in hotel REITs?. *Journal of Hospitality Financial Management*, *28*(1), 2.
Gu, Z., & Kim, H. (2002). Determinants of restaurant systematic risk: a reexamination. *The Journal of Hospitality Financial Management*, *10*(1), 1–13.
Haron, R. (2014). Capital structure inconclusiveness: evidence from Malaysia, Thailand and Singapore. *International Journal of Managerial Finance*, *10*(1), 23-38.
Haron, R. (2018). Firm level, ownership concentration and industry level determinants of capital structure in an emerging market: Indonesia evidence. *Asian Academy of Management Journal of Accounting & Finance, 14*(1), 127-151.
Haron, R., Othman, A.H.A., Nomran, N.M., & Md Husin, M. (2020). Corporate governance and firm performance in an emerging market: the case of Malaysian firms. *Handbook of Research on Accounting and Financial Studies*. US: IGI Global, 208-226.
Ibrahim, K., & Haron, R. (2016). Examining systematic risk on Malaysian firms : panel data evidence. *Journal of Global Business and Social Entrepreneurship*, *1*(2), 26–30.
Iqbal, M. J., & Shah, S. Z. A. (2012). Determinants of systematic risk. *The Journal of Commerce*, *4*(1), 47–56.
Jaafar, M. N., Muhamat, A. A., Basri, M. F., & Alwi, S. F. S. (2020). Determinants of systematic risk: empirical evidence from Shariah compliant firms listed on Bursa Malaysia. *International Business Education Journal*, *13*(1), 71-82.
Kim, W. G., Ryan, B., & Ceschini, S. (2007). Factors affecting systematic risk in the US restaurant industry. *Journal of Tourism Economics*, *13*(2), 197-208.
Lu, J. R., & Chen, C. C. (2010). Effect of oil price risk on systematic risk from transportation services industry evidence. *The Service Industries Journal*, *30*(11), 1853-1870.
Milionis, A. (2011). A conditional CAPM: implications for systematic risk estimation. *The Journal of Risk Finance*, *4, 306-314*.
Nguyen, T. D. T., & Vo, D. H. (2019). The determinants of systematic risk in Vietnam. *Journal of Advances in Decision Sciences*, *23*(2), 1-21.
Organisation for Economic Cooperation and Development - OECD (2018). Economic outlook for Southeast Asia, China and India 2019: Towards smart urban transportation. Retrieved from https://www.oecd.org/development/asia-pacific/01_SAEO2019_Overview_WEB.pdf
Pham, T.N., & Vo, D.H. (2019). Estimating sectoral systematic risk for China, Malaysia, Singapore, and Thailand. *Annals of Financial Economics*, *14*(3), 1-18.

Rowe, T., & Kim, J. (2010). Analyzing the relationship between systematic risk and financial variables in the casino industry. *UNLV Gaming Research & Review Journal*, *14*(2), 47-57.

Securities Commission (2016). Shariah Compliant Listing. Retrieved from https://www.sc.com.my/api/documentms/download.ashx?id=77ef86e2-0718-478e-b381-b4f65d240c57

Wongbangpo, P., & Sharma, S. C. (2002). Stock market and macroeconomic fundamental dynamic interactions: ASEAN-5 countries. *Journal of Asian Economics*, *13*(1), 27–51.

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 146-154
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Shariah Governance in Islamic Financial Institutions in Indonesia and Malaysia: A Comparative Analysis

Muhammad Nazmi Mohd Asri*, Mukhtar Arif Siraj, Elsha Robbi Mighfari, Rizal Nazaruddin Firli

IIUM Institute of Islamic Banking and Finance
International Islamic University Malaysia, Kuala Lumpur, Malaysia

**Corresponding author: muhdnazmy2@gmail.com*

Abstract

Islamic finance and banking in Indonesia and Malaysia have seen significant growth regionally and globally due to the effective implementation of Shariah Governance (SG) in their respective Islamic Financial Institutions (IFIs). Hence, this study aimed to comparatively analyse Shariah Governance frameworks practiced in IFIs in these two countries. The study adopted a qualitative analysis based on a case study of SG in Indonesia and Malaysia. Official documents and policies, particularly Shariah Governance Policy Document 2019 in Malaysia and *Peraturan Bank Indonesia* 2009 in Indonesia, were comparatively analysed according to the responsibilities of the Board of Directors, senior management, Shariah supervisory board and Shariah compliance culture. The study found that SG in Indonesia and Malaysia has several similarities and differences in its SG practices. SG in Indonesia is observed to be not as comprehensive as in Malaysia as the Board of Commissioners and Board of Directors in Indonesian IFIs do not have an active responsibility in SG as compared to Malaysia. Furthermore, SG in Indonesia does not require the establishment of Shariah control functions, and there is also a lack of a robust Shariah non-compliance (SNC) risk management when compared to Malaysia. Nevertheless, the authors believe that the internal policies of Indonesian IFIs would address these issues and strive to enhance the robustness of their SG practices. In the end, the authors hope that the findings from this study would fill the knowledge gap with new developments in SG in Indonesia and Malaysia.

Keywords: Shariah governance, Islamic finance, Islamic financial institutions, Indonesia, Malaysia

1. Introduction

The growth of Islamic banking globally has reached a significant level of systemic importance, as the global Islamic banking assets have reached USD 1.57 trillion in 2018. Particularly in Malaysia, where the Islamic banking assets amounting to 10.8% of the global share and has reported a stable growth resulting in increasing local commercial banking market share to 26.5%. Meanwhile in Indonesia, although possessing only 1.9% of global Islamic banking assets, locally, Islamic banks in Indonesia are gaining market share up to 5.7% in 2018 (IFSB, 2019). Therefore, to ensure the continuous positive growth, one of the key factors is to implement a robust set of organizational arrangements, in which Shariah compliance as the foundation of Islamic banking is prudently supervised and managed, known as Shariah Governance (SG) (Hasan, 2007; Nomran and Haron, 2020a).

Previous studies have highlighted that an Islamic financial institution (IFI) with weak SG framework could lead to inefficiency and weak Shariah compliance, which might expose them to Shariah non-compliance (SNC) risk (Hasan, 2007; Najwa et al., 2019). Grassa (2016) recorded that SG can affect the credit ratings of Islamic banks. Other than that, Basiruddin and Ahmed (2019) studied the relationship between the roles of the Board and Shariah Committee (SC) in SNC risk in Islamic banks in Malaysia and Indonesia for the period 2007-2017. They found that financial expertise among the Board and SC and frequency of SC meetings lowers SNC risk and overall strong SG contributes to the reduction of SNC risk. Hence, SG plays a crucial role in

Article history:
Received 6 November 2020
Revised 15 December 2020
Accepted 22 December 2020

maintaining the integrity of IFIs and boosts confidence among investors and the public alike which directly contributes to the growth of IFIs.

Nevertheless, it is observed that there have been some developments in the current practice of SG, particularly in Malaysia with the recent introduction of the Shariah Governance Policy Document 2019 by Bank Negara Malaysia. This might have several effects on the growth of Islamic banking and finance in Malaysia. Since it is proven that good SG contributes to the growth of the industry, Indonesia is also a good example in SG, which has also seen significant growth over the years. Hence, a comparative study is needed to evaluate the practice of SG and the gaps between the two countries.

Therefore, this study aims to achieve these research objectives, which are to explore the SG practice in IFIs in Indonesia and Malaysia, and to compare the SG practices in IFIs in Malaysia and Indonesia. Findings from the study seek to answer these questions: How is SG practiced in IFIs in Indonesia and Malaysia? How different are the SG practiced in IFIs in Indonesia and Malaysia?

To achieve these objectives, this study adopted a qualitative research methodology by utilizing a comparative analysis of the SG practice in Indonesia and Malaysia. Data is collected from secondary sources such as public documents and official policies. The data is then analysed based on the responsibilities of the Board of Directors (BOD), Shariah Committee (SC), senior management, Shariah control functions and overall transparency. The main contribution of this study is to fill the knowledge gap in light of the latest developments in Malaysia and Indonesia regarding SG in Islamic banks. Furthermore, with the comparative analysis carried out in this study, SG will be further strengthened in the future by improving any gaps observed in this study, hence benefitting all Islamic banks, stakeholders and their customers. Nevertheless, this study is limited to the SG frameworks in two countries i.e. Malaysia and Indonesia. Hence, with constant development in the Islamic finance industry, further research would be recommended on other countries.

This study consists of four sections. The first section introduces the background of the study, problem statement, research objectives and questions, contributions and organisation of the research. Meanwhile, the second section reviews the past literature on SG generally and specifically in Malaysia and Indonesia. The literature review is divided into three parts, beginning with an overview of SG, followed by its implementation in Islamic banks in Malaysia and Indonesia. The third section presents the discussions, findings on the comparative analysis conducted between both countries. Lastly, the fourth section concludes the study with a summary of the study, and the contributions of the study to the policymakers and the Islamic finance industry as a whole. The study ends with the limitations of the study and recommendations for future research.

2. Literature Review

2.1 Brief Overview of Shariah Governance

It is worth noting that corporate governance practiced in conventional banks is fundamentally different from Shariah governance (SG) practiced in Islamic Financial Institutions (IFIs). Although there may be several elements from both frameworks to be similar, SG is principally derived from Shariah rules (Mizushima, 2014; Nomran and Haron, 2020a). IFSB (2009) defined Shariah Governance systems for IFIs to be: the set of institutional and organisational arrangements through which an IFI ensures that there is effective independent oversight of Shariah compliance over each of the following structures and processes: (i) Issuance of relevant Shariah pronouncements/ resolutions, (ii) Dissemination of information on such Shariah pronouncements/resolutions to the operative personnel of the IFI who monitor the day-to-day compliance with the Shariah pronouncements/resolutions vis-à-vis every level of operations and each transaction, (iii) An internal Shariah compliance review/audit for verifying that Shariah compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified, and (iv) An annual Shariah compliance review/audit for verifying that the internal Shariah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Shariah board. Meanwhile, Bank Negara Malaysia (2010) defined SG as “a set of organisational arrangements through which IFIs ensure effective oversight, responsibility and accountability of the BODs, management and Shariah committee”. In the Indonesian banking practice, Bank Indonesia (2009) defines Corporate Governance as bank governance that applies five principles, namely (i) transparency; (ii) accountability; (iii) responsibility; (iv) professional; and (v) fairness.

Previous studies have observed different models of Shariah supervisory systems in IFIs in Southeast Asia and GCC countries. It can be observed that Malaysia and Indonesia practice a dual Shariah supervisory system, where there is a Shariah supervisory board at the regulator's level and an internal Shariah committee at every IFI. On the other hand, Bahrain does establish a higher Shariah Board in its Central Bank however, it only supervises the Central Bank in Shariah matters. Meanwhile, other GCC countries delegate this role to government bodies responsible for religious matters in the case of UAE, Kuwait and Qatar, despite only exercising its role when there is a conflict of opinions in the internal Shariah committees (Grassa, 2016; Nomran and Haron, 2020b).

2.1 Overview of Shariah Governance in Indonesia

Islamic banking in Indonesia is regulated through a special law called Law No. 21 (2008) concerning Islamic Banking. Before the birth of the Shariah Banking Law, the Shariah banking industry was still bound by conventional banking law, namely Law No. 10 (1998), the results of the amendments to Law No. 7 (1992) concerning banking. The Law on Shariah Banking is discussed further and is operational through Bank Indonesia Regulation (PBI) No. 9 and Bank Indonesia Circular Letter (SEBI). The structure of Shariah governance in Indonesia recognizes that there are two levels of Shariah supervision. The first level of supervision is the Shariah board at the national level commonly referred to as the National Shariah Board (DSN), and the second is the Shariah board at the company level called the Shariah Supervisory Board (DPS/SSB). Both institutions are clearly stated in Law No. 21 (2008) and PBI No.6/24/PBI/2004. SSB is an institution formed by the Indonesian Ulema Council (MUI) which has the function of carrying out MUI's tasks in matters relating to Islamic financial activities. MUI is an organization of *ulema* (scholars) associations originating from various Islamic organizations in Indonesia whose status is as a non-governmental organization. The fatwa issued by DSN serves as a guideline for financial institutions that offer Islamic financial services. Even though the DSN organizational status is a non-governmental organization, the *fatwa* issued specifically related to financial transactions is of a binding nature for Shariah financial industry players as stipulated in Article 26 of Law No. 21/2008 concerning Islamic banking.

The other entity responsible for supervising Islamic banks compliance to Shariah principles is referred to as the Shariah Supervisory Board (SSB) in Law No. 21 (2008) relating to Shariah banking. Any Shariah bank or conventional bank that opens a Shariah Business Unit (UUS) must form a SSB with the task of providing guidance and advice to the BODs and supervising the banks on their activities in compliance with the Shariah principles. Supervision of the implementation of *fatwa* issued by DSN is carried out by the SSB at the company level. SSB as explained by PBI No.11/33/PBI /2009 is a board that is in charge of providing advice to the directors and overseeing bank activities to be in accordance with Shariah. As such, SSB is a unique institution in the Shariah governance system in Indonesia which is an extension of DSN based on approval from Bank Indonesia. SSB plays a role in bridging the relationship between Bank Indonesia and the DSN. In a sense, SSB mediates the DSN *fatwa* into Bank Indonesia regulations. SSB supervision covers two things, namely (i) supervision of the bank's new product development process; and (ii) supervision of banking activities.

2.2 Overview of Shariah Governance in Malaysia

Meanwhile, in Malaysia, in accordance with the Central Bank of Malaysia Act 2009, under section 51 and 52, Bank Negara Malaysia (BNM) has established the highest authority in Shariah supervision of IFIs in Malaysia known as the Shariah Advisory Council (SAC). Its role is to ascertain the Islamic law relating to financial matters, advises BNM on Shariah issues and provides advice to any IFIs. In addition, BNM has the legal right to specify standards on Shariah matters for licensed Islamic banks, licensed takaful operators, Islamic windows and foreign IFIS branches (IFSA 2013 Sec. 29(2)) and prescribed development financial institutions (DFIs) carrying out Islamic financial business (DFIA 2002 Sec. 41 and 129). Similar to Indonesia, Malaysia also adopts a two-tier Shariah supervision methodology whereby the SAC sits at the apex level aforementioned and the Shariah Committee (SC) which must be established at every IFI (IFSA 2013 Sec. 30(1)). It is the SC's responsibility to evaluate business policies and operations of every IFI to adhere to SAC Shariah Guidelines. This is also the case with conventional banks operating an Islamic banking business to follow related provisions of IFSA 2013 (Sec. 15).

3. Discussion and Findings

3.1 Shariah Governance Practice in IFIs in Indonesia and Malaysia

Good Corporate Governance (GCG) implementation in Islamic banks is explained through *Peraturan Bank Indonesia* (PBI) No. 11/33 / PBI / 2009. This PBI in general explains the concept of GCG for Shariah banks and Shariah Business Units and how the respective roles of the Board of Commissioners, Directors, Committees, and Shariah Supervisory Board. In this PBI also explained about the format of self-assessment of GCG implementation in Islamic banks. The Shariah supervision section explains the appointment mechanism for SSB members, tenure, duties and responsibilities, reporting mechanism for SSB supervision results and sanctions for SSB who do not carry out their obligations. Although these guidelines are quite comprehensive, they cannot yet be referred to as a comprehensive SG framework model for Shariah banks. The format of the GCG guidelines tends to be the result of adjustments to the GCG guidelines for conventional banks previously issued by Bank Indonesia.

The difference only lies in the existence of the SSB in the company's organizational structure. A more detailed explanation of the technical implementation of GCG for Islamic banks is described through BI Circular Letter (SEBI) No. 12/13 / DPbS / 2010. In addition to the laws and regulations issued by Bank Indonesia, MUI also issued Decree No. 03 of 2000 concerning the Appointment of the Implementation of the Appointment of Members of the SSB at IFIs. It explains the terms, duties and functions and the concurrent membership of the SSB. Since DSN-MUI is not a government organization, the *fatwa* product issued is not binding and final. But based on PBI No. 6/24 / PBI / 2004 has actually made *fatwas* on Shariah banking and Shariah finance issued by DSN-MUI obligatory to become a reference for financial institutions offering Shariah financial products and services (refer DSN-MUI, 2000-2007).

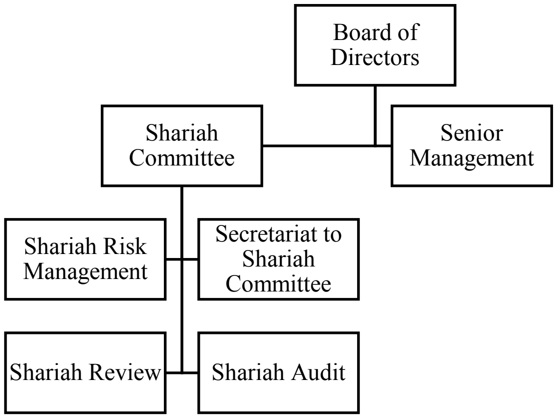
Based on the description of the regulatory aspects of the Shariah governance framework, it can be concluded that there are three main parties that play an important role in Shariah supervision in the banking system in Indonesia, namely Bank Indonesia which is currently switching to the Financial Services Authority (OJK), the National Shariah Council under the organization of the Ulema Council Indonesia and the SSB formed at the company level. The laws and regulations governing SSB are regulated separately from conventional banking laws. The law that was published was further elaborated through PBI and SEBI including related to the supervision of Shariah aspects.

On the other hand, Bank Negara Malaysia as the regulator in Malaysia has established the Shariah Advisory Council (SAC) to supervise all Islamic banking and takaful activities. Meanwhile, at the micro level, all IFIs are obligated to form a Shariah Committee (SC) to issue guidance and advice regarding Shariah matters internally. In 2011, BNM established the Shariah Governance Framework in Malaysia, highlighting the responsibilities of the organs of Shariah Governance including the Board of Directors, Shariah Committee, Senior Management and Control Functions.

However, recently in 2019, BNM has revised the SGF superseded by the Shariah Governance Policy Document (SGPD, 2019), which took effect on 1 April 2020 except Para. 12.5, is expected to be effective on 1 April 2023. The provision in this particular paragraph requires SC members to serve in a single IFI not more than nine (9) years. Hence, there is a delay to allow the current sitting of SC members in IFIs to retire and allow new members to be appointed. Furthermore, in this SGPD, it can be observed that several amendments have been made and extra attention has been given, especially on the roles of the Board to further strengthen SG in IFIs. Figure 1 shows the organizational structure of Shariah Governance.

IFIs in Malaysia are obliged to implement the SGPD (2019) including licensed Islamic banks, licensed takaful operators and professional re-takaful operators, licensed banks and licensed investment banks approved to operate Islamic banking business, prescribed development financial institutions approved to operate Islamic banking business, as well as foreign IFIs branches in Malaysia. Other than that, Shariah committee members are also required to adhere to relevant provisions. In the SGPD, it is categorized into several aspects including highlighting the responsibilities of the Board, Shariah committee (SC), senior management and control functions in Shariah governance in IFIs and instilling a Shariah compliance culture in governance, as well as maintaining transparency.

Figure 1: Organizational Structure of Shariah Governance (Malaysia)



Source: SGPD (2019)

First, the Board has the active role to approve and oversee the implementation of SG structure, evaluate the performance of senior management in implementing SAC's resolutions and SC's advice and decisions (Para. 8.1 of SGPD 2019). Importantly, the Board members have to strengthen their knowledge in Islamic banking and finance (Para. 8.2) and give due diligence to SC's advice and decisions (Para. 9.1). To ensure that SC may exercise its duties effectively, the Board must establish a formal evaluation process for SC members (Para. 9.6) and a rigorous selection process for appointment, re-appointment and cessation of SC (Para. 12.12), other than ensuring objectivity and independence of SC (Para. 9.2), establish a policy for conflict of interests (Para. 9.3) and provide a suitable remuneration policy for SC (Para. 9.7). The Board also must establish an effective communication policy with SC and review the frequency and quality of their engagements (Para. 9.4).

Second, the Shariah Committee (SC) must provide sound advice and decisions in an objective manner in Shariah matters (Para. 10.10) including supervising operations that would trigger Shariah non-compliance events, affirming them and approving rectification plans (Para. 10.2). The SC is also required to devise a robust methodology for its decision-making process (Para. 10.4) and referral has to be made to SAC in which the resolution has not been made by SAC or a decision cannot be determined by SC (Para. 10.6). For SC meetings, it must be held at least once every two months for local IFIs (Para. 11.2) and twice annually for foreign IFIs (Para. 11.3). SC members must devote time to prepare and attend the meetings (Para. 10.11) at least 75% in a financial year (Para. 11.4). The majority of SC members must be present at the meeting (Para. 11.7) and decisions are made based on simple majority (Para. 11.8). SC meetings shall be led by the SC Chairman and is also obliged to devise development plans for SC members to strengthen their knowledge on the business of the IFIs and market developments (Para. 10.14).

The IFIs must also disclose the frequency of meetings, attendance of SC members (Para. 11.6) and ensure accurate records of minutes of SC meetings (Para. 11.14). The IFIs must also ensure that SC has full access to information (Para. 11.10), provide third party experts if necessary (Para. 11.11) and obstruction of access shall be informed to the Board (Para. 11.12). An SC member must be a qualified person (Para. 12.1, 12.2), free from any conflict of interests (Para. 10.13, 12.4), may be appointed to one licensed Islamic bank, one Takaful operator and one prescribed institution at the same time (Para. 12.7) and must not be an active politician (Para. 12.8). The IFIs thus must ensure that the size of SC shall be appropriate with the business size of the IFI and be conducive for Shariah deliberations (Para. 13.1) with at least five members for local IFIs (Para. 13.2) and three members for foreign IFIs (Para. 13.4). The Secretariat of SC have the responsibilities to: (i) Coordinate communication between Board, senior management and SC, (ii) Research and studies on Shariah issues, (iii) Provide day-to-day advice to relevant parties to implement SAC rulings or SC decisions, (iv) Ensure dissemination of information to whole IFI, (v) Secretarial roles (Para. 14.1), where items (ii) & (iii) must be carried out by Shariah qualified person(s) (Para. 14.2). The Secretariat also must plan Shariah meetings that give sufficient time to SC members to deliberate/make sound decisions (Para. 14.3).

Third, the senior management of the IFIs led by the CEO shall establish a management structure and reporting arrangement that highlights the accountability of each SG units. The senior management has to implement SG policies, SAC rulings and SC advice and decisions and an effective communication policy to promote Shariah understanding across the IFI. Senior management of IFIs is required to evaluate operational support given to SC, and lastly, notify the Board and SC for potential or actual SNC risk (Para. 15.1). All senior management are required to consistently develop their understanding in Islamic finance and its developments (Para. 15.2).

Fourth, Shariah non-compliant (SNC) risk in IFIs must be managed by three control functions: Shariah risk management, Shariah review and Shariah audit (Para. 16.3). The IFIs are obliged to provide sufficient resources to these control functions (Para. 16.4), ensure that they work independently (Para. 16.6), and have access to all business lines that are exposed to SNC risk (Para. 16.7). Specifically for Shariah risk management, they are responsible for the integration of the SNC management structure with the whole IFI. Most importantly, they have to identify SNC risk in the IFI business, assess SNC risk and measure the potential impacts, construct mitigation measures, monitor SNC risk exposure and evaluate mitigation measures. Lastly, they shall notify the Board, SC and senior management of any SNC risk. Shariah risk management is also required to challenge any decisions that may trigger SNC risk (Para. 17.2).

As for Shariah review, they are responsible to identify, assess and monitor IFI business according to Shariah and report to the Board, SC and senior management of SNC issues and findings. They also have to provide updates on legal and regulatory requirements regarding the IFI business, as well as, provide guidance and training to IFI officers (Para. 18.2). As for Shariah audit, they are responsible to establish an audit methodology to assess risk profile of the IFI, establish an audit plan, provide clear audit programs to guide internal auditors to gather information, auditing procedure and assessment, and to deliver the audit results to the Board and SC through an audit report complete with findings and recommendations for rectification measures (Para. 19.2). All officers in each control function shall possess relevant knowledge in respective functions and Shariah knowledge (Para. 17.4, 18.4, 19.4).

Lastly, the IFIs must exercise transparency and disclose the oversight accountability of Shariah governance implementation of the Board and the overall Shariah compliance of the IFIs in their annual reports. In addition, their respective SC shall disclose their responsibilities in the implementation of SG and their opinion on the IFIs compliance to Shariah (Para. 22.1). All disclosures must not be false, misleading, inaccurate or incomplete (Para. 22.5). For the SC, the IFI must have a policy for the SC to form an opinion on the overall compliance of the IFIs to Shariah (Para. 22.7). The SC shall convey their opinion on whether there is no SNC event in the IFIs, or there is an SNC event(s) with details on its nature, status and plans for rectification (Para. 22.9, 22.10).

3.2 Comparative Analysis

We analysed the main policy documents concerning SG in Malaysia and Indonesia respectively i.e. SGPD 2019 and PBI 2009, and it can be observed that both policies are issued by the respective Central Banks. However, regarding its applicability to IFIs, the SGPD covers Islamic banks, takaful operators, licensed banks approved to carry out Islamic banking business, prescribed development financial institutions approved to carry on Islamic financial business, foreign IFIs in Malaysia and Shariah committee members, whereby the PBI only covers Islamic banks, Islamic windows and SSB. This is because takaful operators and DFIs are regulated by the Indonesian Financial Services Authority (OJK).

As previously mentioned, both countries have a Shariah council at the regulator's office, but the SAC is established under BNM which is a government body, meanwhile the DSN is established under MUI which is a non-governmental organisation. The distinction lies in the status of these entities as a government entity and as a non-governmental organization. However, resolutions and *fatwas* issued by these entities are legally binding on all IFIs. At the institutional level, both countries oblige IFIs to establish a Shariah committee. A unique distinction is that SGPD lays out the responsibilities of the units to specifically implement SG, whereby PBI establishes control functions to implement general Good Corporate Governance with some Shariah governance elements.

Table 1: Differences between SGPD 2019 (Malaysia) and PBI 2009 (Indonesia)

Aspects	SGPD 2019	PBI 2009
Responsibilities of Board of Directors (BOD)/ Board of Commissioners (BOC)	SGPD requires the BOD to acquire relevant knowledge on IBF to effectively implement Shariah principles in IBF	PBI does not require this
	SGPD requires the establishment of Shariah control functions (Shariah risk management, Shariah review and Shariah audit)	PBI obliges the BOC to establish a Risk Monitoring Committee, Remuneration and Nomination Committee and Audit Committee
	SGP requires the BOD to engage with the Shariah Committee, document their engagements and develop a conflict resolution mechanism in SC	PBI does not require this
Responsibilities of Shariah Committee/ Shariah Supervisory Board	SGPD emphasizes on the mitigation of Shariah non-compliance risk (SNC)	PBI does not specifically highlight Shariah non-compliance risk (SNC)
	SGPD highlights on the responsibilities of the SC Chairman	PBI does not require this
	SGPD specifically requires SC to develop a methodology for their decision-making process	PBI does not require this
	SGPD obliges the Secretariat to the SC to perform supporting roles for the SC	PBI does not require this
Appointment, Cessation, Disqualification and Composition of SC/DPS members	SGPD dictates that SC shall comprise of at least five members	PBI does not specifically dictate the number of persons to be SSB members
	SGPD limits the service tenure for an SC member of a maximum nine years in an IFI	PBI does not put an absolute maximum limit on the service tenure for SSB members, instead it depends on the longest service tenure of directors or commissioners
Responsibilities of Senior Management/Board of Directors	SGPD requires the senior management to have relevant knowledge in Islamic banking and finance, as well as the latest developments in the industry	PBI does not require this
Responsibilities of Shariah Control Functions	SGPD requires the establishment of Shariah risk management, Shariah review and Shariah audit	PBI requires at least one (1) independent member in the Audit Committee to be knowledgeable in Islamic banking
Transparency and Shariah Compliance Culture	SGPD requires IFIs to disclose any SNC events and endorsed by the Board and SC	PBI does not require this

Source: SGPD (2019) and PBI (2009)

It can be observed that SG for IFIs in Indonesia and Malaysia are similar in terms of the law and technical regulations. The difference is that Malaysia has developed a more comprehensive framework using the term specifically, 'Shariah Governance'. Meanwhile in Indonesia, it is still using the corporate governance perspective for IFIs. This is because Indonesia adopted this from the IFSB Guidelines No. 10 (Governance for Financial Institutions Offering Islamic Financial Products and Services) (Rama, 2015). In practice, this is reflected in the responsibilities of the Board of Commissioners and Board of Directors focusing on good corporate governance practices, while the SSB is the only unit which has an active function in SG.

In the Malaysian SGPD, the BOD and senior management are required to actively engage in the fulfilment of Shariah governance by frequently conducting meetings with the SC and developing relevant knowledge about Islamic banking and finance. However, in Indonesia, the responsibilities of the BOC and BOD are more focused on corporate governance elements, rather than Shariah governance. Nevertheless, it is important to note that IFIs in Malaysia are also obliged to follow corporate governance principles as laid down in the Malaysian Code of Corporate Governance (Securities Commission, 2017).

Furthermore, in carrying out the duties of oversight of Shariah compliance in IFIs, the Shariah Committee (SC) in Malaysia is assisted by the Shariah control functions, which are: Shariah review, Shariah audit and Shariah risk management, and they are separate and independent in the organizational structure with other existing units or functions. On the contrary in the regulatory system in Indonesia, the existence of Shariah units or functions is not mentioned directly. The unit or function is integrated with units or functions that already exist in the organizational structure of the company, such as the internal audit unit and the control department. Last but not least, the SGPD specifically emphasizes on the management and mitigation of SNC risk, unlike in Indonesia, this specific risk is not directly mentioned in their policies. However, IFIs in Indonesia are most likely to adopt certain countermeasures in their internal policies to assess and mitigate SNC risk, although the guidelines from regulators do not require Indonesian IFIs to do so. For example, this may be seen with the presence of officers with Shariah background in the Audit Committee and Risk Monitoring Committee to evaluate this SNC risk.

4. Conclusion

Indonesia and Malaysia each use two levels of supervision, namely at the macro level where there is a Shariah advisory council role i.e. SAC of Malaysia and MUI of Indonesia, in the standardization and harmonization of Shariah provisions, and at the micro level there is a Shariah Committee (SC) or Shariah Supervisory Board (SSB) that regulates the implementation of the *fatwa* at the institutional (IFIs) level. Although there are quite a lot of regulations related to the SG system in Indonesia, it cannot be said that Indonesia already has a comprehensive SG regulatory framework. This is because the guidelines in the form of PBI (*Peraturan Bank Indonesia* 2009) and SEBI (*Surat Edaran Bank Indonesia*) issued by Bank Indonesia are not comprehensive to be a robust SG system. The SG system in the regulation point of view is still a sub-section, especially only located in the Shariah Supervisory Board. Meanwhile in Malaysia, SG is considered as important as good corporate governance. This is portrayed in a specific policy document, the SGPD 2019, outlining clear responsibilities of each Shariah governance units, SNC risk reporting and Shariah compliance culture within the IFI.

Therefore, the existence of a regulatory framework regarding SG systems for IFIs in each of these jurisdictions must properly be established by the relevant authorities to create harmonization of regulations in the framework for integration of Shariah financial system in Indonesia and Malaysia. Future research may also empirically evaluate the effectiveness of SG practices and its impacts on the performance of IFIs. Furthermore, since the scope of the current study is the SG practices based on the regulations of the respective countries at a macro level, a study based on the internal policies of SG in IFIs in Indonesia is recommended to evaluate whether their implementations in actuality are more robust or at par with the required provisions from the regulators.

Acknowledgement
The paper has been presented at the International Conference on Islamic Social Finance: Pandemic Crisis and Possible Solutions (Online) organized by the IIUM Institute of Islamic Banking and Finance on 29th – 30th September 2020. We thank the reviewers and the Journal Editor for the constructive comments for further improvement of the paper.

References

Basiruddin, R., and Ahmed, H. (2019). Corporate governance and Shariah non-compliant risk in Islamic banks: evidence from Southeast Asia, *Corporate Governance*, *20*(2), 240-262.

Shariah Governance Policy Document (SGPD) (2019), Accessed from: https://www.bnm.gov.my/index.php?ch=57&pg=144&ac=836&bb=file

Bank Negara Malaysia (2011), Accessed from: https://www.bnm.gov.my/index.php?ch=57&pg=137&ac=163&bb=file

DSN-MUI (2000-2007). Kumpulan Fatwa Dewan Syari'ah Nasional Majelis Ulama Indonesia. Accessed from: https://www.ojk.go.id/id/kanal/syariah/regulasi/fatwa-dsn-mui/default.aspx

Grassa, R. (2016). Shariah supervisory system in Islamic financial institutions: new issues and challenges: a comparative analysis between Southeast Asia models and GCC models, *Humanomics*, *29*(4), 333-348.

Hasan, A. (2007). Optimal Shariah governance in Islamic finance. *Islamic Finance News*, *4*(14), 7.

Islamic Financial Services Act (2013). Accessed from: https://www.bnm.gov.my/index.php?ch=en_legislation&pg=en_legislation_act&ac=222&full=1&lang=en

Islamic Financial Services Board (IFSB) (2019). Islamic Financial Services Industry Stability Report 2019. Accessed from: https://www.ifsb.org/download.php?id=5231&lang=English&pg=/index.php

Islamic Financial Services Board (2009). Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services. Accessed from: https://www.ifsb.org/download.php?id=4366&lang=English&pg=/published.php

Mizushima, T. (2014). Corporate governance and Shariah governance at Islamic financial institutions: assessing from current practice in Malaysia. *Reitaku Journal of Interdisciplinary Studies*, 22(1), 59-84.

Nomran, N.M., & Haron, R. (2020a). A systematic literature review on Shariah governance mechanism and firm performance in Islamic banking. *Islamic Economic Studies*, *27*(2), 91-123.

Nomran, N.M., & Haron, R. (2020b). Shari'ah supervisory board's size impact on performance in the Islamic banking industry: an empirical investigation of the optimal board size across jurisdictions, *Journal of Islamic Accounting and Business Research*, *11*(1), 110-129.

Najwa, N.A., Ramly, Z., & Haron, R. (2019). Board size, chief risk officer and risk-taking in Islamic banks: role of Shariah supervisory board. *Jurnal Pengurusan*, *57*, 1-19.

Peraturan Bank Indonesia (PBI) (2009). Peraturan Bank Indonesia Nomor 11/33/PBI/2009 Tentang Pelaksanaan Good Corporate Governance Bagi Bank Umum Syariah dan Unit Usaha Syariah. Accessed from: https://www.bi.go.id/id/peraturan/perbankan/Pages/PBI_71209.aspx

Rama, A. (2015). Analisis sistem tata kelola Syari'ah bagi perbankan Syari'ah di Indonesia dan Malaysia. *Jurnal Bimas Islam*, *8*(I), 87-120

Surat Edaran Bank Indonesia (SEBI) (2010). Accessed from: https://www.bi.go.id/id/peraturan/perbankan/Documents/e1abe36b84984a359ebc1cd669a27265se_121312.pdf

Securities Commission Malaysia (2017), Accessed from: https://www.sc.com.my/api/documentms/download.ashx?id=70a5568b-1937-4d2b-8cbf-3aefed112c0a

Journal of Islamic Finance, Vol. 9 No. 2 (2020) 155-158
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Book Review
An Introduction to Islamic Finance
Mufti Muhammad Taqi Usmani

Reviewer: Mohyedine HAJJAR

Paris I University (Panthéon-Sorbonne)
Paris VIII University

mohyedine.hajjar@gmail.com

The book *An introduction to Islamic Finance* by the renowned Pakistani scholar Mufti Muhammad Taqi Usmani is an indispensable reference in its field of scholarship. Even after twenty years, the book remains one of the gateways to Islamic finance despite the remarkable developments in industry and the predominant scholarly production.

The author remains a reference in the world of Islamic banking and finance. His writings are works of reference for researchers as well as practitioners. The choice of the presentation of this Book Review is partly based on the worldwide fame of its author in addition to the particular characteristics of this book that we will cite.

1. Presentation of the Work

The book was completed on 9 June 1998, i.e. 04 rabīᶜ al-awwal 1419H, as indicated at the end of the author's introduction, and was published several times in paper format:

- Karachi: Idara Isha'at-e-Diniyat (P) Ltd. (January 1st, 1999).
- Netherlands: Kluwer Law International (January 1st, 2001), in Arab and Islamic Laws Series.
- Karachi: Maktaba maᶜāriful qur'an (2002).

The book has been translated and published in Urdu:

- *Islamī binkārī kī yunādī*, translated by Muḥammad Zāhid, Fayṣal Abād: Maktabat al-ᶜĀrifī, 1428H.

In addition, the book has just been translated and published in Arabic:

- *Muqddima fī al-tamwīl al-islāmī,* translated by ᶜUmar Aḥmad Kashkār, Damascus: Dār al-Rawād, 2019.

Finally, an electronic version of the book is available online on the author's official website[1]. This online publication makes the book accessible to the general public far from the geographical boundaries or logistical constraints that may stand against the acquisition of a paper version of the book[2].

These different editions show the importance of this work, which remains a great classic in the field to this day. We have compared the electronic version with the last edited version, and we can confirm that the book has not been subject to any changes in substance. Only formal changes appear as a slightly different layout and a few spelling mistakes corrected.

2. In the Content

This book, *An Introduction to Islamic Finance*, is not an original writing but rather a compilation of articles and conference papers as the author states in his introduction[3]. The author begins his work with an

---

[1] Available on the following link:
https://muftitaqiusmani.com/en/books/PDF/An%20Introduction%20To%20Islamic%20Finance/An_Introduction%20_to_Islamic_Finance.pdf

[2] In this paper we rely on the electronic version in the pagination of our references to facilitate the return of the readership of this paper to the author's developments.

[3] See p.7.

introductory chapter presenting the characteristics of Islamic economic thought, the relationship between the human, the divine and the money, and a critique of the capitalist economy[4]. He has taken care to cover all the contracts of Islamic finance, each with a dedicated article in order to produce this book. Each chapter dedicated to a contract explains its legal regime in classical Islamic law and its use and role in the Islamic banking, finance and insurance industry. One chapter is dedicated to Islamic funds and another to the principle of limited liability in Islamic law.

In our opinion, we thought it was more appropriate to add chapters dedicated to Islamic banking and Islamic insurance in order to cover the whole discipline in this book.

We thus note that the book is characterized by its legal dimension which is in fact the essential characteristic of Islamic finance. A student in finance, management, law or economics aiming to learn about Islamic finance needs this side of legal theory in order to understand the peculiarity of this sector. All the particular aspects of Islamic finance in all these sides (legal, accounting, financial) are based on the legal particularities of contracts in traditional Islamic law. This is why the dominant legal dimension of the book seems to us one of its major assets.

3. Writing Style

The language of the text is reasonably understandable and intended for the general public. A novice reader who is not familiar with the financial world would have no trouble accessing the substance of the text. This is an asset for this book as it meets the needs of the target audience.

However, we note that much of the development in the book corresponds to the form of oral discourse. The text is loaded by remarkable stylistic gaps. We find quite a few poorly composed passages and the majority of the sentences are long and weakly organized. It is common to encounter sentences exceeding one third of a page. It is possible that this deficiency is at the origin of the chapters of this book, i.e. conference papers intended to be presented orally. In any case, this deficiency had to be remedied as the book's various editions progressed.

4. Bibliography

In the official electronic version, the footnote numbering is continuous in each chapter and start over in the following chapter. This indicates the bibliographical independence between chapters of the book and reminds us that its origin is a compilation of articles and conference papers. In our opinion, it was more judicious to opt for a continuous enumeration for the whole document or an enumeration that starts again with each new page.

We also note that a bibliographical list is missing which lists down all the references mentioned by the author in his work. This is an important formal gap.

5. Miscellaneous remarks

We will quote a few remarks that we found there, although they are secondary. Some of them have to do with spelling, terminology or form.

Some quotes, mostly Qur'anic verses, prophetic *ḥadīths* or legal sayings, are produced in Arabic. However, the book is intended for the general public, mainly non-Arabic speakers, it makes more sense to translate them into English.

Among the spelling mistakes, we notice omitted letters or prepositions. In the majority of cases, these are simple mistakes that have no impact on the text. However, an omitted preposition changes the meaning, or even exposes the opposite of the intended meaning, in the following passage:

Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but, this sinful act does not render the whole business of the borrower as harâm or impermissible. The borrowed amount being recognized as owned by the borrower, anything purchased in exchange for that money is not unlawful. Therefore, the responsibility of committing a sinful act of borrowing on interest rests with the person who wilfully indulged in a transaction of interest, but this fact does render the whole business of a company as unlawful[5].

[4] pp.9-16.

[5] See p.143.

The idea outlined by the author explains that the unlawful act of lending at interest does not make the entire activity unlawful. The last sentence summarizes the idea, but the absence of a "not" has reversed the meaning. The original passage should be corrected by adding this word in square brackets as follows: "*but this fact does [not] render the whole business of a company as unlawful*". Note that the latest paper version of the book does not contain this error[6].

In the following passage, we also notice an imprecision in the text impacting the meaning:

In some cases, the bank purchases the commodity from abroad at a price payable after three months or in different instalments, and sells the commodity to his client before he pays the full price to the supplier. Since he pays the price in dollars, its equivalent in Pakistani Rupees are not known at the time when the commodity is sold to the client[7].

The bank must be designated by the third person dedicated to things and not to humans, namely "*it*". This error is repeated throughout this passage. The use of "*he*" results in mixing between the bank and the customer in this passage. In fact, it is the bank that pays the price in dollars, the sentence should be: "*Since [it] pays the price ...*". In attention in reading this very technical passage could easily lead the reader to misunderstand the meaning and the translator to a mistranslation with a misunderstanding. Another spelling mistake - not leading to misunderstanding - also exists in the previous passage. It was necessary to say, "*its client*" instead of "*his client*", but it is clear that we are talking about the bank's client.

We also note the use of a terminological concept in a different sense from what it is known in the Islamic financial industry. The concept *ṣukūk* refers to Islamic financial securities representing underlying assets in a project, they are quite distinct from units in Islamic investment funds. However, the author has proposed to name Islamic fund securities by *ṣukūk, which* raises a terminological concern. The author says:

"These certificates may preferably be called "ṣukūk", a term recognized in the traditional Islamic jurisprudence"[8].

Even if the concept *ṣukūk* is recognized in the Islamic legal tradition and can be attributed to any title representing an asset, it cannot be admitted, nowadays, for any financial title compatible with *Sharīah*. Indeed, the said notion has a very precise terminological meaning and the ṣukūk have become financial securities *Sharīah* compliant representing a co- ownership of the underlying assets, the AAOIFI standard provides: "*certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity*"[9]. The author could avoid attributing this nomenclature to the shares of Islamic funds and did not need to enter into this terminological quarrel.

The author also presented a disputed and problematic solution. The late payment charges imposed on a contractor cannot benefit any of them, in particular the financial institution, but must be paid in charity. The charitable use of these funds must be ensured in scrupulous respect of the aforementioned standards. The author proposes in his developments to group the compensation for delay in a fund intended to finance people in need. He says:

"The lessee may be asked to undertake that, if he fails to pay rent on its due date, he will pay certain amount to a charity. For this purpose the financier / lessor may maintain a charity fund where such amounts may be credited and disbursed for charitable purposes, including advancing interest-free loans to the needy persons"[10].

[6] See the edited version of the book, (2002) Karachi: Maktaba maᶜāriful qur'an, p.207.
[7] See p.101, and in the edited version, p.144.
[8] See p.147 and in the edited version, p.213.
[9] See AAOIFI, *AAOIFI Norms*, *Shari'ah* Standard N No. (17): Investment Sukuk, art.2.
[10] See p.120.

However, this proposal is in our view a violation of the ban on taking advantage of late payment benefits. When the financier uses these allowances to finance the needy without compensation, he benefits directly from this activity in terms of marketing, relationships, and, indirectly in the economic benefit. Such a charitable purpose cannot be left to the management of the financial institution because it merges with its main activity of credit institution in the view of the public. This confusion still remains even if the announcement and communication take place under the name of this charity fund held by the bank[11].

In the chapter dedicated to the contract of *Ijāra*, the author uses the term "*leasing*" as a translation of *Ijāra*. Thus, he uses this term to designate both leasing (civil law contract) and financial leasing (financing contract). We can understand the meaning well according to the context, but it was possible to use different notions for this. The author could use the term "leasing" exclusively to refer to the financing contract, and the term "rent" to refer to the lease. This kind of nuance is important in educational works for students and the general public.

We also thought it was more appropriate to add representative diagrams of each contract or funding arrangement to make the content more accessible to beginners. This brings the book closer to its intended audience.

6. Conclusion

An Introduction to Islamic Finance is a great classic an introductory work to Islamic finance that we believe is indispensable for those wishing to learn about Islamic finance. The work is of high quality and has manystrengths. Some of the shortcomings mentioned deserve to be corrected or remedied in the coming editions of the book without, however, touching on its importance. We proposed the addition of several elements: chapters on Islamic banking and Islamic insurance; explanatory diagrams. We think that a new edition taking into account the previous remarks will lead to a better formal presentation worthy of this high-quality work.

[11] Note that Islamic banks use this practice.

JOURNAL OF ISLAMIC FINANCE

AIM AND SCOPE OF JOURNAL OF ISLAMIC FINANCE

Journal of Islamic Finance (JIF), published biannually (June and December), is a double blind peer-reviewed open-access journal of the IIUM Institute of Islamic Banking and Finance, International Islamic University Malaysia (IIUM). The journal is designed to provide a platform for researchers, academicians and practitioners who are interested in new knowledge and discussing ideas, issues and challenges in the fields of Islamic banking, finance, accounting, business and economics. The scope of the journal includes, but is not limited to, Islamic banking and Finance, Islamic capital market, Islamic wealth management, issues on Shariah implementation and practices of Islamic banking and Finance, zakat, waqf, takaful and comparative analysis of Islamic and conventional financial institutions.

REFEREES' NETWORK

All papers submitted to the Journal of Islamic Finance will be subjected to a rigorous reviewing process through a worldwide network of specialized and competent referees. Each accepted paper should have at least one positive referee's assessment.

SUBMISSION OF A MANUSCRIPT

A manuscript should be submitted online to the Journal of Islamic Finance at https://journals.iium.edu.my/iiibf-journal/index.php/jif/login. Further correspondence on the status of the paper could be done through the journal website.

Journal of Islamic Finance
ISSN: 2289-2109 E-ISSN: 2289-2117