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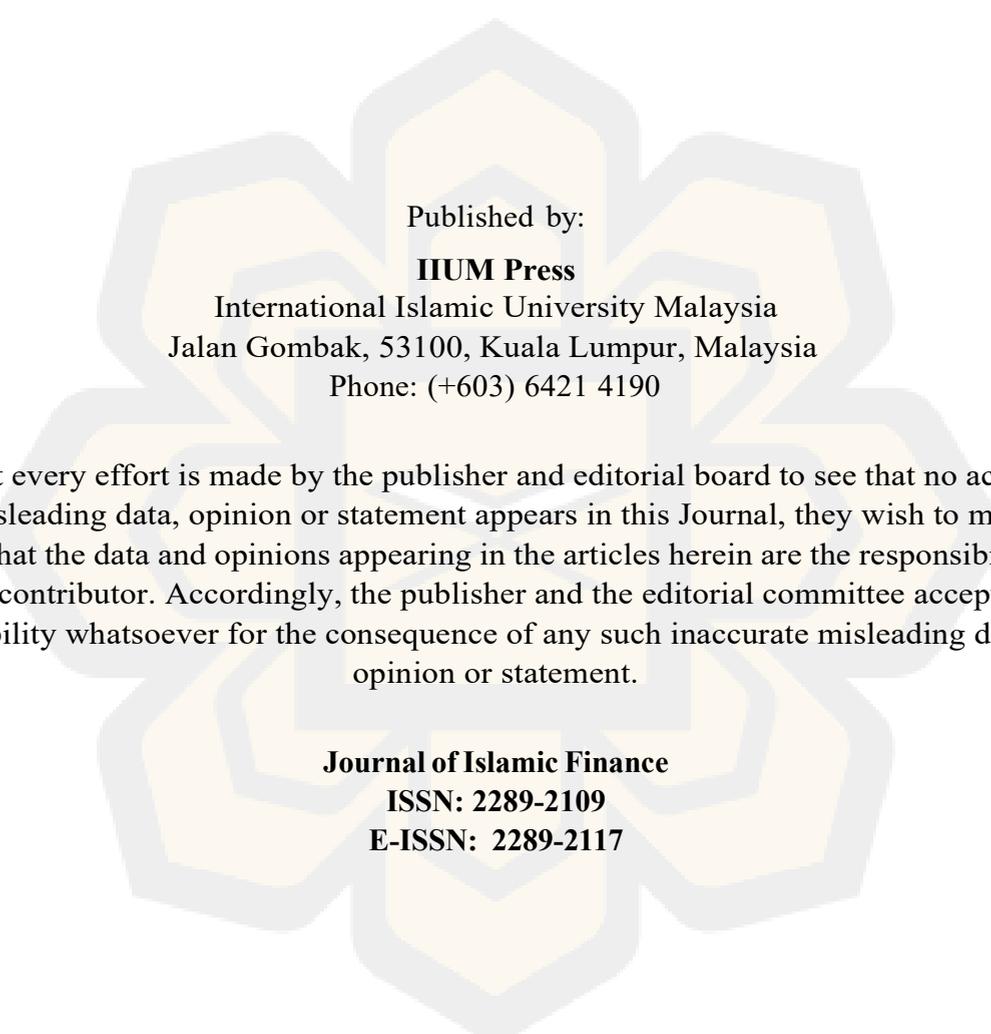
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Developing Sustainable Islamic Banking System In Afghanistan: Insights From Malaysia's Success

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Abstract

This paper investigates the potential for developing a sustainable Islamic banking system in Afghanistan, drawing on Malaysia's advanced and successful model which holds approximately 65% of Sharia-compliant banking assets in the region. Islamic banking, grounded in Shari'ah principles such as the prohibition of interest (riba), uncertainty (gharar), and gambling (maysir), has garnered significant global attention due to its ethical foundation and appeal to communities seeking Shari'ah-compliant financial solutions. With over \$2 trillion in assets, Islamic banking has made a profound impact worldwide. Malaysia's dual banking system, inclusive regulatory framework, and innovative Shari'ah supervisory model have positioned it as a global leader in Islamic finance. However, Afghanistan, despite its challenges, has yet to develop a fully functional Islamic banking system. This study proposes that Afghanistan could benefit from adopting Malaysia's model, emphasizing the necessity of a robust legal framework, financial literacy, and an inclusive environment for Islamic financial products. Particularly in terms of regulatory framework, shariah governance and financial inclusion. Utilizing a qualitative research methodology, the paper concludes that with strategic planning, collaboration, and a commitment to financial inclusion, Afghanistan has the potential to build a modern, ethical, and growth-driven Islamic banking system.

Keywords: Development, Islamic Banking, Afghanistan, Malaysian.

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1. Introduction

The essential aim of Islamic banking is to generate profits for both the institution and its depositors through a financial transaction in which giving and receiving interest is strictly prohibited. To achieve this, Islamic banks must have clear and well-defined policies and adhere to certain restrictions governing their business activities. These processes must be carefully designed and implemented for the bank to commence operations. This study delineates the essential Islamic principles required for Islamic banks to operate and examines the guidelines for depositors. It emphasized the importance of adhering to these principles to ensure that the bank maintains a prudent approach in evaluating business opportunities, resisting the allure of potentially high but non-compliant profits. Islamic banking has witnessed significant development in several Islamic countries, with Malaysia standing out as a global leader in this domain. The rapid development of Malaysia's Islamic banking is due to laws, regulations, administrative, and technological frameworks that have made it the leader in the global Islamic industry. On the contrary, Afghanistan's Islamic banking sector remains in its early stages, requiring

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substantial growth and development. This study aims to draw upon Malaysia's successful and pioneering experience as a model to propose practical strategies for the advancement of Islamic banking in Afghanistan, enabling the country to implement and enhance this sector effectively.

2. Literature Review

2.1 Definition of Islamic Banking

Islamic banks avoid interest payments, generating profits through the actual exchange of goods and services. In parallel, the monetary authorities regulate the money supply, adjusting it to the actual availability of assets in Islamic states (Seyd Othman & Aljunid, 2017). The monetary authority regulates the exchange rate of tangible assets like gold and silver for the national currency, ensuring the economy is based on productive and ethical transactions. Therefore, Islamic banking is a financial institution that operates in accordance with the principles of sharia, raises and invests the funds, aiming to foster societal development, promote justice in wealth distribution, and contribute to economic growth while adhering with Islamic moral and social values. It provides services such as loans, savings, and investments while adhering to ethical financial principles (Dusuki & Abdullah, 2011).

2.2 The Global Count of Islamic Financial Institutions as of 2024

As of 2024, the global Islamic finance industry continues to grow, with over 1,600 institutions managing more than \$3.38 trillion in assets, Islamic banking continues to be the largest segment of the IFSI, constituting 70.21% of the total global IFSI assets in 2023 (IFSB, 2024). This successful sector has experienced annual growth rates of 15% to 25%, with notable expansion in the Gulf Cooperation Council (GCC) countries, Southeast Asia, and increasingly in regions such as Central Asia and the Asia-Pacific (S&P Global, 2024). Notably, countries like Afghanistan and other central Asia show rising demand for Sharia-compliant financial services. Islamic banks have spread to more than 30 non-Muslim countries, including the US, UK, Germany, and Australia. The UK has become a leading location for Sharia-compliant banks such as the Bank of London and the Middle East and Qatar Islamic Bank and is considered a global hub for sukuk issuance. The UK market is expected to grow at a CAGR of 3.12% between 2024 and 2029, reaching assets of \$8.7 billion (IFSB, 2024). In the US, Islamic finance is growing in real estate and healthcare, while in Germany and Australia, real estate and sukuk development are focused. South Africa is also active in Islamic finance, offering Sharia-compliant services and sovereign sukuk (Mordor Intelligence, 2024). This global expansion reflects a growing demand for ethical financial products that align with Islamic principles, attracting both Muslim and non-Muslim investors across diverse financial markets. Modern Islamic banking emerged in the 1960s to comply with sharia law. Key developments include the establishment of the Mit Ghamr Savings Bank in Egypt in 1963, followed by the Islamic Development Bank in 1975, and the establishment of the first full-fledged Islamic bank, the Dubai Islamic Bank. The sector has grown since the emergence of Islamic banking, Islamic equity investments, takaful, and sukuk (Seyd Othman & Aljunid, 2017). Islamic banking in Malaysia began in 1983 with the establishment of Bank Islam Malaysia Berhad (BIMB) under the Islamic Banking Act, initiating a dual banking system. Malaysia has since become a global leader in Islamic finance, with innovations like the Malaysia International Islamic Financial Centre (MIFC) and the development of Sharia-compliant government securities (Seyd Othman & Aljunid, 2017). The Islamic banking sector in Malaysia has expanded significantly, with 41% of funding in 2023 sourced from Islamic finance. Innovations like Aeon Islamic Digital Bank continue to drive growth, solidifying Malaysia's leadership in global Islamic finance. Afghanistan has 12 conventional banks, including three government-owned, seven private, and two foreign bank offices (Centre for Strategic and Regional Studies, 2022). Islamic banking is gradually expanding, with the Islamic Bank of Afghanistan (IBA), the first fully Sharia-compliant bank, transitioning from Bakhtar Bank in 2018. With \$25 million in capital and \$187 million in deposits across 59 branches, the sector still faces challenges, as only 5.7% of the population engages with banking, highlighting significant untapped potential (Disli et al., 2023a). Afghanistan's Islamic banking sector is valued at approximately \$610 million. Some conventional banks have launched Islamic banking windows, including the National Bank of Afghanistan and the United Bank of Afghanistan in 2008, and Maiwand Bank, Ghazanfar Bank, and Kabul Bank in 2009. In 2015, the International Bank of Afghanistan also launched an Islamic banking window (Naseri, 2020). These developments reflect the increasing integration of Shari'ah-compliant services in Afghanistan's banking system. Following the rise of the Islamic Emirate of Afghanistan, all banks were instructed to cease usury-based transactions and align with

Islamic banking principles. The regulation allows a two-year period for converting conventional banks to Islamic ones (Alami et al., 2021). Da Afghanistan Bank (DAB) and the Islamic Emirate of Afghanistan aim to expand Islamic financial services in response to growing public demand. Despite challenges such as limited infrastructure, low public awareness, and regulatory barriers, Islamic banking is viewed to enhance financial inclusion and stimulate economic activity (Centre for Strategic and Regional Studies, 2022). By 2024, more than 1,600 Islamic financial institutions including banks, takafuk companies and investment firms will operate in more than 80 countries, with a total value of more than \$3.38 trillion. Key markets driving this expansion include the GCC, Malaysia, and nations like Indonesia, Iran and Pakistan (IFSB, 2024).

2.3 Requirements To Establish An Islamic Banking

Islamic banking's establishment requires several critical components including a robust legal framework, adequate capital requirements, well- defined governance, comprehensive risk management strategies, a diverse range of Shariah-compliant products, and skilled human resources. Furthermore, the development and operation of Islamic banking institutions must address various challenges and considerations to maintain compliance with Islamic principles while achieving financial stability and growth (Dusuki & Abdullah, 2011).

2.3.1 Legal Framework

The establishment of Islamic banks requires a robust legal and regulatory framework that are in line with Shari'ah principles and conventional banking regulations. In Islamic financial institutions (IFIs), this framework is essential to maintain fair operation integrity and build confidence. These include regulatory development, sharia compliance, and Licensing and auditing (Uddin et al., 2024).

2.3.1.1 Regulatory Developments

Around 20 nations have established formal legal frameworks for Islamic banking, with notable examples including Sudan, Kuwait, Iran, Pakistan, and Saudi Arabia, which implemented Islamic banking laws in 1980, 2003, 1983, 2001, and 2007 respectively (Dusuki & Abdullah, 2011). Other countries, including Afghanistan, Jordan, Qatar, Oman, and Bahrain, have implemented partial Islamic banking laws. Non-Muslim majority nations, like the UK, have also adopted tax neutrality laws (Amuda & Al-Nasser, 2024).

Indonesia's Sharia Banking Law was enacted in 2008, while Malaysia's Islamic Financial Services Act 2013 established a comprehensive legal framework for Islamic banking. The IFSA ensures Shariah compliance, consumer protection, and risk management protocols. Malaysia, a global leader in Islamic finance, distinguishes its operations from conventional banking (Salisu & Saniff, 2023).

Afghanistan lacks a dedicated legal framework for Islamic banking, with a draft law under review awaiting cabinet approval. The legislation's adoption is crucial for establishing a formal structure for Islamic banking development and regulation, ensuring Shariah compliance, and fostering stakeholder confidence (Naseri, 2020).

2.3.1.2 Sharia Compliance

Shariah law, which prohibits practices such as Maysir (gambling), Gharar (excessive uncertainty), and Riba (interest), extortion and frau, serves as a fundamental prerequisite for the operations of Islamic financial institutions (IFIs)(Uddin et al., 2024). Therefore, global IFIs must comply with Shariah rules in terms of products and services, and regulators must clearly maintain good and effective governance structure, and practice to maintain market discipline enforced by supervisory authorities, and foster trust in the Islamic banking system (Dusuki & Abdullah, 2011).

2.3.2 Licensing And Supervision

Islamic banks must meet strict licensing criteria, including implementing a robust corporate governance framework for effective investment monitoring by account holders. In jurisdictions such as Malaysia, mandates Islamic financial institutions (IFIs) to adhere to Shariah governance, risk management, and Central Bank compliance standards at individual and group levels (Salisu & Saniff, 2023). The Central Bank of Bahrain sets eight licensing conditions in Module LR, aligning with international benchmarks like Basel Committee and IFSB (The Islamic Financial Services Board, is an international body based in Malaysia that sets global

prudential standards to ensure the stability and sound regulation of Islamic finance), for initial licenses and operational legitimacy, and ensuring alignment with global regulatory practices (Abozaid & Khateeb, 2024).

2.3.3 Capital Requirements

Islamic banks in some countries like Ethiopia, Kazakhstan, Turkey, the UAE, and the UK must meet identical capital adequacy standards, influenced by the Basel Committee on Banking Supervision framework (BCBS). However, local regulatory preferences can vary, leading to variations in application across these countries (Dusuki & Abdullah, 2011). On the contrary, Bahrain, Jordan, Malaysia, and Sudan modify capital adequacy requirements to align with Islamic banking characteristics, following IFSB rules to better reflect the distinctive tenets of Islamic finance. Islamic banks must maintain a capital adequacy ratio (CAR) between 8% and 12% of their risk-weighted assets (Ismail & Zulkhibri, 2024). Capital adequacy is measured by the "alpha" metric, which varies by location and regional budget, and is influenced by governance systems, making international comparisons challenging. Malaysia requires all sources from investment funds to be converted into risky assets, while Sudan set this ratio at 50%, Bahrain and Jordan set it at 30%. Standardization of Islamic banking capital regulations is essential to improve comparability and financial stability (S&P Global, 2024).

2.3.4 Governance Structure

To preserve operational efficiency and ensure adherence to Shariah principles, Islamic banks' (IBs') governance structure is essential. This structure is characterized by a wide range of obligations and responsibilities, particularly regarding Shariah compliance, which is essential to the validity of financial operations in the context of Islamic banking. An essential part of governance in Islamic banks is the Shariah Supervisory Board (SSB), which is composed of specialists in Islamic commercial jurisprudence (fiqh al-mu'amalat) (Wasim Jan, 2020). The SSB is responsible for business audits, zakah calculation principles, documentation of financial instrument, and processing of non-compliant revenue income. Its fatwas are binding and consist of at least three to six members. The SSB examines banks' operations to ensure compliance with Shariah regulations, with some jurisdictions having their own boards (Tashkandi, 2022). Shariah committees and other business governance systems are part of the governance structure of Islamic banks, aiming to reduce agency issues and ensure transparency. This dual governance, which combines Shariah oversight with traditional processes, is significant for decision-making and strategy development, and requires clear accountability in every workplace (Muhamad Sori et al., 2015).

2.3.5 Operational Infrastructure

This element encompasses both internal control and compliance system, and risk management framework:

2.3.5.1 Internal Controls

To ensure compliance with Sharia law and financial rules, the bank needs to set up strong internal controls and compliance procedures. This includes creating accounting systems that monitor asset-backed transactions, profit and loss sharing, and avoiding interest-based transactions (Algabry et al., 2020).

2.3.5.2 Risk Management

Islamic banks (IBs) face unique risk management challenges due to their Shariah-compliant activities. To maintain stability and compliance, a comprehensive risk governance framework is needed, including policies, procedures, systems, and controls (Ismail & Zulkhibri, 2024). Additionally, Islamic banks must monitor and report Shariah-compliant vehicles, manage operational, credit, liquidity, and market risks, and implement risk management systems in line with the Sharia risk-sharing model, avoiding forbidden actions (Song & Oosthuizen, 2014). Finally, Islamic banks (IBs) require license, documentation, operational infrastructure, sharia governance, branch operations, management control, capital management, and fiduciary responsibilities. These requirements regulate the level playing field for Islamic banks.

2.3.6 Sources Of Funds In Islamic Banking And Its Application

There are different sources of funds in Islamic banking such as Shareholders, Equity based on joint-venture profit sharing, customer's deposits in current Account based on Wadi'ah Yad Damanah, Customers deposits in saving Accounts based on Wadi'ah Yad Damanah, Customers deposits in general investment Accounts based

on Mudarabah/ trustee profit- sharing, customers deposits in special investment accounts based on Mudarabah/ trustee profit- sharing as well (Khan & Mirakhor, 1986). One of the essential application parts for the bank is statutory reserves that the bank maintains with the central bank based on Wadi, ah Yad Damanah, liquidity requirements based on Qard al-Hasan; it is also the statutory requirement that the bank maintains certain ratios of defined liquid assets to its various types of deposits at all times. This ratio is given by the central bank from time to time. After meeting the reserve requirements and holding the necessary assets, the banks are free to use the remaining customer’s deposits and the shareholders. funds for banking operations like project financing based on Mudarabah, musharakah, Bay, Bithaman Ajil, financing the use of services of asses like Ijarah, syndication services like fees, and security and debt settlement according to Bay, al Dayn (Dusuki & Abdullah, 2011). Each has its own Islamic bank structures and models. The bank provides short-term financing to meet the operating and working capital needs of its customers. These facilities include LC Letters of Credit, LG Letters of Guarantees, and financing operations based on Murabahah, wakalah, musharakah, and Murabahah. The bank uses customers’ deposits and shareholders' funds to invest in musharakah form, while the treasury department manages short-term funds, foreign exchange, and trade money (Al- wadi & Samhan, 2016).

2.3.7 Products And Services Development

Islamic banks promote financial inclusion and avoid interest by offering Shari'a-compliant products and services. They provide advice on transaction amounts, timings, benefits, terms, structure, performance, and features of these instruments, increasing in number daily (Dusuki & Abdullah, 2011). Banking services are divided into assets and liabilities, which are vital for financial stability and the balance sheet of banks. Assets, such as current assets, are economic assets owned by a bank and used to generate income, meet obligations, and invest surplus cash. Liabilities are the obligations of a company, including debts and unpaid services, and are divided into current (short-term) and non-current (long-term). These include deposits, Ruhn, unpaid bills, deferred revenues, wages, and other debts. Islamic banks generally provide a wide range of services and products, including deposits, investments, financing through Mudarabah, joint venture contracts, and other instruments such as Istisna'a, Salm, Muzara'at, Musaqat, Magharist, and Ijarah. It also includes investments in securities such as sukuk, bank guarantees, bank transfers, letters of credit, and credit cards (Al- wadi & Samhan, 2016). The chart below exhibits the features of Islamic Bank’s Balance Sheet.

Table 1: Assets and Liabilities of Islamic Banking

Assets	Liabilities
Inventory Rear asset/ Automobiles Ownership of asset	Demand Deposits Wadiah (safe custody)/ Qard (loan)
Asset backed Transactions Murabahah (cost plus)/ Ijarah (leasing)/ Istisna (manufacture)/ Salam (forward delivery)	Investment account Mudarabah (profit sharing)
Profit Sharing Transactions Mudarabah (profit sharing)/ Musharakah (profit and loss sharing)	Special Investment Account Mudarabah (profit sharing)
Fee Based Services e.g. Ujrah, Wakalah(Agency), Kafalah (Guarantee)., etc.	Profit Equalisation Reserves As prudential tool

(Dusuki & Abdullah, 2011)

2.3.8 Common Finance Models In Islamic Banking

Shariah contracts in trade and commerce can be categorized into trading contracts, participating contracts, and supporting contracts. There are ten shariah contracts commonly used in Islamic banking, including Murabaha, Istisna, Bay, Bithaman Ajil, Ijrah thuma al Bay, Bay, al Salam, Qard Hasan, Bay, al Inah, and Bay, al Dayn (Al- wadi & Samhan, 2016). Trust services are crucial in Islamic finance for trust creation, management, and administration, while developing Shari'a-compliant products requires caution to avoid stifling innovation, especially in markets with lower religiosity (Dusuki & Abdullah, 2011).

2.3.9 Human Resources: Roles, Responsibilities, Qualifications, Experience, And Ethical Considerations

In Islamic banking, the human resources division plays a crucial role in maintaining Shari'ah compliance and regulatory standards. The internal Shari'ah control department, in collaboration with the Shari'ah Supervisory Board (ISB), is responsible for ensuring adherence to Shari'ah regulations, refraining from issuing independent fatwas (Suwandaru et al., 2023). Executives in departments dealing with risk acquisition and control must monitor performance targets while ensuring organizational goals and legal requirements are met. Establishing an Islamic bank requires specialized human resources with qualifications such as a professional certificate in Shari'ah and Islamic banking from organizations like AAOIFI and CIBAFI, as well as a university degree in Islamic Shari'ah or related fields. Some jurisdictions require 10 years of Shari'ah supervision experience, certification programs like CIBP, and ethical recruiting practices, including proficiency in English and Arabic for effective communication within the workforce (Zafar & Jafar, 2024).

2.3.10 Technology And Infrastructure

They are important, particularly in the contemporary era, which includes both IT systems and e-banking services. Therefore, it is crucial to establish modern banking institutions with digital platforms that will manage customer account, banking transactions, and products in accordance with Sharia law. In addition, the IT infrastructure must comply with security and governance requirements. Also, the bank must provide electronic banking services that comply with Islamic finance standards, allowing users to manage funds, conduct transactions and apply for loans online without using products or interest (Riza & Wijayanti, 2024).

2.3.11 Engagement Of The Market And Stakeholders

To support competitive bidding and stakeholder engagement, it is significant to engage with the industry and stakeholders through market research and engagement with local citizens to build trust and ensure that the company's products are shariah compliant. Key regulations that can be introduced for Islamic financial institutions are to ensure that they operate in a shariah-compliant manner and to support the long-term growth, sustainability, and stability of the global financial system (Salahudin et al., 2019).

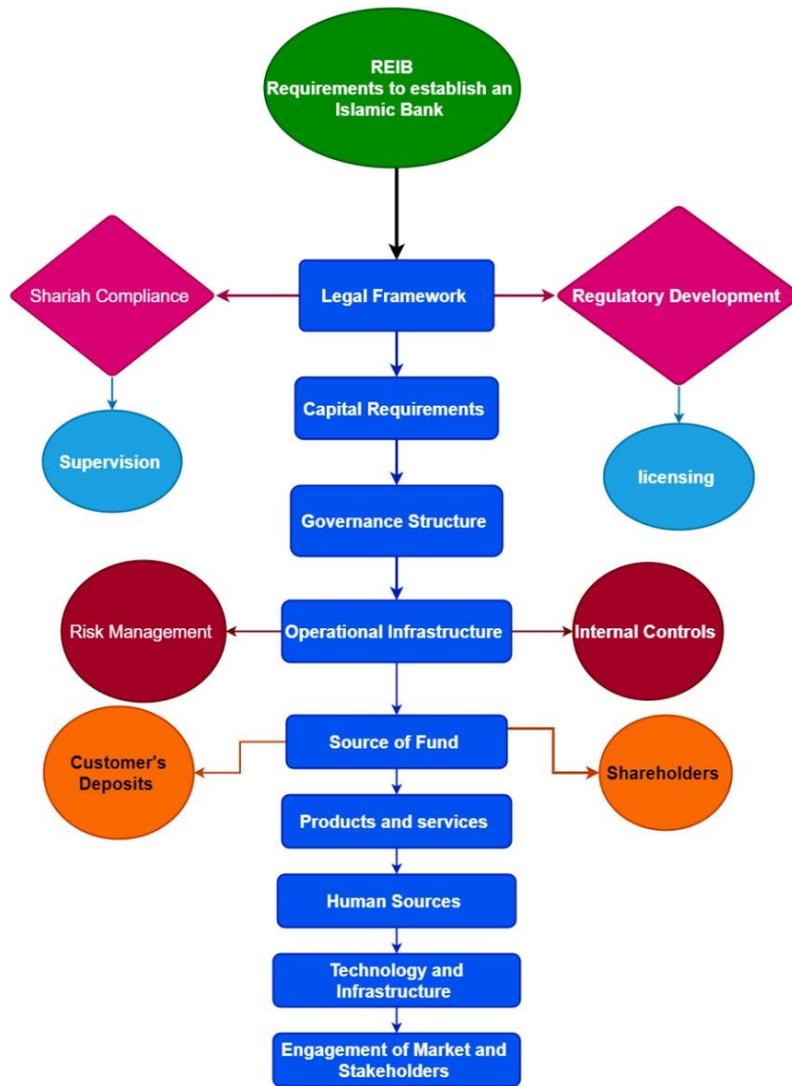


Figure 1: The requirements of establishing an Islamic bank

2.4 Challenges And Considerations (Regulatory Framework, Risk Management, Market Dynamics, Financial Viability And Societal Factors)

Establishing an Islamic bank requires compliance with regulatory requirements that vary by region. While some countries have set comprehensive standards for conventional and Islamic banks, specific requirements for Sharia compliance and governance are often required. These frameworks can vary; some jurisdictions provide broad legal provisions to Islamic banks, while others may offer limited regulatory support, resulting in differences in systems (Salisu & Saniff, 2023). Islamic banks face unique challenges in managing business, operations, and Shari'ah-compliance risks due to capital allocation and liquidity constraints, interest requirements management, and approval principles. Challenges such as liquidity shortage, insecurity in the secondary market, and lack of public understanding hinder investment attraction and asset management. Islamic banks need to develop business plans that include financial forecasting, capital adequacy, performance monitoring, and risk assessments to ensure financial profitability and build trust, especially in Muslim-majority regions (Abozaid & Khateeb, 2024).

2.5 Malaysia's Pioneer Islamic Banking System

Malaysia's advanced Islamic banking system provides Sharia-compliant financial services, exemplifying a balanced approach to modern banking practices. It operates alongside conventional banking under a dual framework and is supported by a robust regulatory environment. Afghanistan could benefit from Malaysia's governance experience, including finance, digital transformation, risk management, and cross-border investments (Salisu & Saniff, 2023).

2.6 Historical Overview Of The Malaysian Financial System

2.6.1 Malaysia's Economic Development Under Vision 2020

Malaysia's economic development has evolved through successive strategies, each building on the successes and challenges of previous plans. A country's development strategy is determined by long-term, medium-term, and short-term plans for the country's economic development. Vision 2020 is a long-term strategy to make Malaysia a global hub and an industrialized nation for Islamic finance with a high per capita income. Due to socio-political and economic factors, Malaysia's colonial development strategies failed to meet the social needs required to stabilize the economy and further fueled economic concerns. British colonial rule in Malaysia displaced the indigenous Malay populations, resulting in significant wealth and education inequality. The Chinese dominated key industries, and the Malays were marginalized (Mahmoud & Mitkees, 2017). Post-independence in 1957, Malaysia was faced with the challenge of maintaining its ethnic diversity and promoting economic growth. Capitalism prevailed until the 1960s, and by the time the Federation of Malaysia was formed in 1963, agriculture had become the main industry, accounting for 39.3% of GDP and employing more than 60% of the workforce, but the economy was still in decline (Seyd Othman & Aljunid, 2017). Malaysia avoided property confiscation or nationalization due to ethnic tensions, adopting an inclusive approach allowing Chinese, Indians, and Malays to collaborate in economic and political development. Malaysia's first plan (1966-1970), implemented between 1957-1969, revitalized local economies by integrating and transforming the Malay population into the economy. Despite these efforts, the plan continued to face challenges such as a high poverty rate, lack of entrepreneurship, and unemployment, leading to conflict (Devadas et al., 2020). The 1969 uprising led the government to develop a new strategy. Malaysia's New Economic Policy (NEP) was implemented between 1970 and 1990 with the aim of addressing social inequalities and promoting economic growth. It was divided into five plans: the Second Plan (1971-1975), the Third Plan (1976-1980), the Fourth Plan (1981-1985), and the Fifth Plan (1986-1990). By 1990, the NEP had increased the Malay's share of the country's GDP from 2.4% to 30%, reduced poverty from 49.3% to 16.5%, and achieved an annual GDP growth rate of 7.8% between 1971 and 1990 (Seyd Othman & Aljunid, 2017). In 1991, Mahathir Mohamad launched Vision 2020, a comprehensive development plan that aimed to transform Malaysia into an industrialized country by 2020, focusing on the Malaysian people, the economy, capital, the role of Islam and state. Vision 2020 aims to quadruple Malaysia's per capita income since 1999, establish Malaysia as a global leader in Islamic finance, and address the challenges of globalization. Mahathir has outlined nine major initiatives to promote solidarity, fair trade, social justice and social research, which have been implemented through a series of strategic initiatives over the years (Devadas et al., 2020). The National Development plan (NDP) (phase 1) from 1991 to 2000 aimed to eradicate poverty, reduce social and economic inequality, and further advance the objectives of the New Finance Act. The New Democratic Party implemented two five-year strategies, The Sixth Five -Year Plan (1991-1995), and the Seventh Five-Year Plan (1996-2000), which focused on developing industrial knowledge and establishing the Malaysian Institute for Microelectronics. Our aim is to increase national investment in public investment and private sector growth through the following. This period also coincides with the 1997 Asian Financial Crisis, which had a major impact on Malaysia's economy (Devadas et al., 2020). Unlike its neighbouring countries that sought assistance from the International Monetary Fund (IMF), Malaysia implemented various domestic measures, including capital controls, to ensure that the country quickly recovered, reduced and improved economic growth. Malaysia prioritized the development of Islamic banking from 2001 to 20210 and targeted Islamic banking to account for 20% of total banking by 2010, thereby creating a resilient economy. A society that is wisely governed can meet the challenges of globalization S&P Global, 2024. The New Economic Model (2010-2020) aims to enhance Malaysia's position as a high-income country while promoting the globalization of Islamic finance. The Financial Markets Development Plan (2011-2020) aims to increase the contribution of financial markets to GDP from 4.3 times to 6 times by 2020, with an annual growth target of 8% to 11%. We aim to create a dynamic and competitive financial system by expanding

the range of Islamic finance products and services. Malaysia has implemented various strategies to support its growth path, including the Third National Plan (2006-2020), the Malaysia Education Plan (2013-2025), and the Malaysian Higher Education plan (2015-2020), to foster growth opportunities. Malaysia's National Commodity Policy and National Food Policy aim to strengthen trade and transport, with a target of full development by 2020 (Bunnell, 2022).

2.6.2 The Impact Of Islamic Banking On Malaysia's Economy

Due to the large number of banks and other financial organizations that offer financial services in compliance with shariah law, Malaysia is a top global leader in Islamic banking, with 16 fully Islamic banks, including domestic and overseas banks, providing financial services in compliance with Islamic law (Devadas et al., 2020). Malaysia's Islamic finance sector, including banking and investment, has grown significantly, particularly in Islamic financial instruments; Malaysia controls one of the largest markets in the world. Malaysian Islamic banks are global market leaders in Sharia-compliant financial services, offering interest-free loans and savings through joint ventures such as Murabaha, and Musharaka, where the benefits are shared between the bank and the customers. Islamic finance in Malaysia encompasses property leasing, commercial finance (Istisna), reduced property finance and cash sales (Murabaha). Malaysia's Islamic finance system includes Sukuk, and Takaful, providing an Islamic alternative to conventional bonds and insurance, supporting Sharia-compliant projects (Mahmoud & Mitkees, 2017). On the other hand, Malaysia's Islamic banking services, guided by Bank Negara Malaysia, adhere to Sharia principles, promoting ethical investments in ethically permissible sectors, fostering growth and stability. Islamic finance is expected to account for approximately 41% of total finance in Malaysia by 2024. This reflects the country's success in promoting Islamic finance domestically and globally. Malaysia is also introducing digital innovations in Islamic banking, providing Sharia-compliant electronic and mobile banking services for account management and transactions. Malaysia is a leading player in digital Islamic banking, introducing digital banks like Aion Bank to improve accessibility and expand Sharia-compliant financial services to marginalized communities (S&P Global, 2024). Malaysia's tech-savvy population is driving the growth of online and digital banking, with banks like Maybank2u, CIMB Clicks, and RHB Now offering comprehensive digital services to meet customer needs. To ensure security, these platforms use transaction verification codes and two-factor authentication (2FA) and are regulated by Bank Negara Malaysia to safeguard against cybersecurity threats. Malaysia's digital banks, such as Sea Bank and GXS Bank, were licensed by Bank Negara Malaysia in 2022, to provide accessible financial services to underserved communities, including rural areas and small businesses (Latip, 2024). Malaysia's banks are enhancing efficiency, low-cost services, and innovative financial solutions, integrating Islamic finance principles into digital platforms to uphold Sharia-compliant banking. Malaysia's online banking sector is expected to grow due to rising internet penetration and favourable regulatory conditions, enhancing financial inclusion and solidifying its position as a global Islamic finance leader (IFSB, 2024).

2.6.3 Shariah Legal Framework In Malaysia's Islamic Finance:

Islamic finance in Malaysia operates within a robust regulatory framework that facilitates the coexistence of conventional and Islamic banks. The Malaysian legal system, based on civil law, places most legal matters under civil courts' jurisdiction (Dusuki & Abdullah, 2011). The rapid growth of Islamic finance is supported by sound legal frameworks. Islamic banking and finance in Malaysia is regulated by government legislation, including the Islamic Banking Act 1983 (requires licensing and regulation), the Banking and Finance Act 1989 (allows conventional banks to offer Islamic banking services), the Malaysian Banking Act 2009 and the Central Bank Act, the financial Development Act 2002, the Direct Sale Act 2009, and the Federal Constitution, the supreme law of Malaysia (Salisu & Saniff, 2023). Key elements of the regulatory framework include the Islamic Financial Services Act 2013 (IFSA), which replaced the Islamic Banking Act of 1983 and provides a comprehensive framework for Sharia-compliant banking operations. Malaysia's Central Bank (Bank Negara Malaysia, BNM) is responsible for overseeing Islamic banking to ensure its growth and compliance with Sharia principles (Jalil & Osman, 2020). The regulatory framework for Islamic banks in Malaysia is overseen by BNM and the Securities Commission of Malaysia (SC). BNM sets Sharia regulatory standards for Islamic banks and takaful operators, while the SC provides guidance to Islamic capital markets. The Sharia Advisory Council (SAC), established by BNM, is the highest authority on Sharia matters in Islamic finance. Islamic banks in Malaysia adhere to Maqasid Sharia, focusing on principles such as the prohibition of Riba (interest),

transparency to avoid Gharar (uncertainty), halal in investments, and a risk-sharing model for cooperation between banks and customers (Wasim Jan, 2020). In Malaysia, waqf (Islamic donation) and zakat (almsgiving) regulations ensure that they are operated in accordance with Islamic teachings. While the State Islamic Religious Councils (SIRCs- (Majlis Agama Islam Negeri -Malaysia's statutory body oversees Islamic affairs, including waqf, zakat, mosque management, and religious education, with authority derived from state enactments and the Federal Constitution, chaired by the Sultan.) manage the waqf assets in accordance with state laws, the country also has government federal entities such as JAWHAR. The management of the waqf is regulated by state laws such as the Waqf (Powers of states) Act, and government regulations aimed at promoting sustainable development and investment. The collection and distribution of zakat is overseen by the Selangor Public Services Commission (SIRC) Lembaga Zakat Selangor, in accordance with state laws, supported by institutions such as the Selangor Zakat Department (Lembaga Zakat Selangor) (Salisu & Saniff, 2023). Modern zakat institutions focus on governance, transparency, and digital solutions. Efforts to integrate waqf and zakat resources, such as using waqf assets for zakat projects, are supported by technological innovations development and research centers such as the International Centre for Waqf and Zakat (ICWZ). This principle promotes social and economic cooperation while adhering to Islamic principles (Seyd Othman & Aljunid, 2017).

2.6.4 Shariah Governance In Malaysian Islamic Finance

Malaysia's regulatory framework, specifically the Shariah Governance Policy Document (SGPD), has significantly influenced Islamic finance and capital markets development. Unlike other countries, Malaysia has a centralized system with Shariah Advisory Councils under Bank Negara Malaysia and the Securities Commission, each with its own SAC (Jalil & Osman, 2020). This centralized approach strengthens Malaysia's leadership in Islamic finance and ensures industry uniformity (Aspiranti et al., 2023). The Shari'ah Advisors Council (SAC) is a group of nine experts in Sharia, Islamic finance, economics, law, and finance who will serve for three years to ensure sound governance in Islamic banks. They play a crucial role in adapting classical legal systems to modern finance through ijthihad, reform, and integration. SAC members must have Arabic language proficiency, Islamic commercial law expertise, collaboration knowledge, and research skills. They must also be innovative, collaborative, team-oriented, and maintain high standards of professionalism while demonstrating humility and acceptance of limitations (Muhammad, 2018). The Securities Commission Malaysia (SC) is led by the Securities Advisory Council (SAC), consisting of at least 10 members appointed by the Minister of Finance with expertise in Sharia, finance, economics, and law. The SAC's policy aims to maintain Malaysia's position as a global leader in Islamic finance, facilitating the growth of Islamic capital, equity, debt, commodity, derivatives, and foreign exchange markets (Salisu & Saniff, 2023). The National Shariah Councils (SACs) in Malaysia oversee Shariah committees to ensure compliance and prevent conflicts. The Shariah Governance Policy Document mandates all Islamic financial institutions (IFI) to establish a committee, consisting of five members, including at least three Shariah experts. These committees approve new products and processes, ensure ongoing compliance through review and audit, and serve three-year terms (Jalil & Osman, 2020). The Shariah Committee at the IFI-level in Malaysia ensures compliance with Shariah principles, submitting periodic reports to SACs, and aligning operations with Shariah principles for governance, product standardization, and Islamic finance acceptance. The committee, comprising key stakeholders, meets bi-monthly, requires 75% attendance, and makes decisions by a two-thirds majority. They work together to ensure Islamic financial institutions (IFIs) adhere to Islamic law principles, encompassing governance, compliance, product development, risk management, and auditing. This an overview of the key committees in IFIs in Malaysia, their functions, and typical members.

1. Shariah Committees (SC)

The Shariah Committee, or Shariah Supervisory Board, is the highest authority within an Islamic Financial Institution (IFI) responsible for ensuring Shariah compliance, providing advisory services, issuing fatwa, resolving disputes, and aligning with Shariah principles, typically comprising 5-7 members with expertise in Islamic law, finance, economics, and commercial law (Uddin et al., 2024).

2. Shariah Review Committee (SRC)

The Shariah Review Committee (SRC) ensures Shariah compliance by reviewing contracts, transactions, and practices against SC guidelines and fatwas. It comprises 3-5 members, including

Shariah scholars, auditors, compliance professionals, and legal or financial experts (Aspiranti et al., 2023).

3. **Shariah Audit Committee (SAC)**
The Shariah Audit Committee, comprising 3 to 5 members, ensures Shariah compliance by monitoring internal processes, transactions, and financial statements, identifying non-compliance, and recommending corrective actions (Algabry et al., 2020).
4. **Shariah Products Committee (SPC)**
The Shariah Products Committee, comprising 3 to 5 members includes Shariah scholars, product managers, and financial professionals with relevant expertise, reviews and develops Shariah-compliant products and services, ensuring adherence to Shariah law, evaluates financial contracts, investment strategies, and new instruments (Seyd Othman & Aljunid, 2017).
5. **Shariah Research Committee (SRC)**
The Shariah Research Committee, comprising 3-7 members, is a research group focused on Islamic finance, law, and economics, aiming to develop new theories for Shariah-compliant products and services, identify emerging trends, and contribute expertise to advance the field and ensure Shariah compliance (Salisu & Saniff, 2023).
6. **Shariah Risk Management Committee**
The Shariah Risk Management Committee, consisting of 3 to 5 members, identifies and manages non-compliant transactions, ensuring risk practices align with Shariah principles, primarily involving Shariah scholars, risk management professionals, and compliance officers (Wasim Jan, 2020).
7. **Shariah Governance Committee**
The Shariah Governance Committee, consisting of 5-7 members, reviews policies, processes, and performance to ensure alignment with Shariah principles and ensures effective compliance across institutions, including Shariah scholars and senior management (Dusuki & Abdullah, 2011).
8. **Shariah Compliance Committee**
The Shariah Compliance Committee, comprising 3 to 5 members including scholars, compliance officers, and auditors, ensures consistent alignment with Shariah law in Islamic Financial Institution operations and guides corrective actions when necessary (Rosli Abdul Aziz, 2019).
9. **Shariah Finance Committee**
The Shariah Finance Committee, comprising Shariah scholars, finance professionals, and investment experts, is responsible for ensuring the financial strategies of Islamic Financial Institutions align with Shariah principles, avoiding prohibited elements like riba and gharar (Muhammad, 2018).
10. **Shariah Investment Committee**
The Shariah Investment Committee, consisting of 3 to 5 members, ensures Islamic law compliance in IFI's investment activities by evaluating opportunities, structuring portfolios, and avoiding prohibited sectors, ensuring alignment with Islamic law (Muhammad, 2018). These committees collectively ensure that IFIs in Malaysia uphold Shariah principles while maintaining robust governance, compliance, and risk management frameworks.

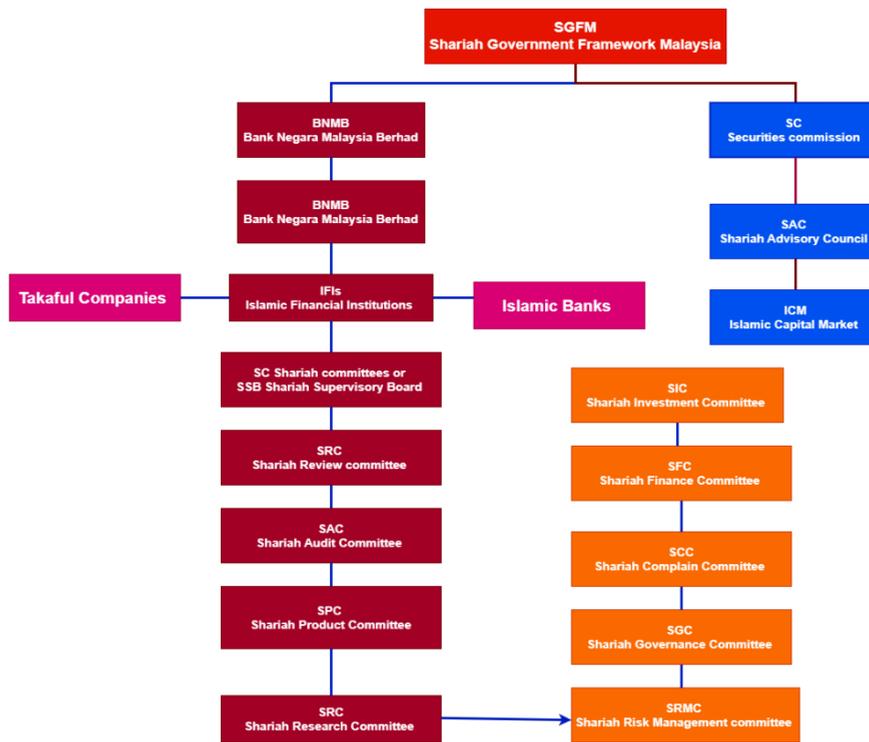


Figure 2: The abobe figure illustrates the Sharia Governance Framework for Islamic banking in Malaysia

2.6.5 Critical Success Factors For Islamic Banking In Malaysia

Malaysia's success in Islamic banking is attributed to strong government support, Sharia compliance laws, and a well-structured legal framework supported by institutions like Bank Negara Malaysia and the Securities Commission (SC), which ensures adherence to Islamic principles, stability, and transparency in the sector (Wasim Jan, 2020). Islamic banking in Malaysia thrives on offering a diverse range of Sharia-compliant products, including Murabaha, Mudarabah, Musharakah, Ijarah, Musharakah Mutanaqisah, Sukuk, Takaful, and ethical investment options (Muhammad, 2018). Malaysia's Islamic banking sector full-fledge, subsidiaries and DFIs, comprising 40% of its banking assets, is expanding due to digital banking innovation, green Sukuk issuance, and halal financing initiatives, demonstrating its leadership in global Islamic finance. Furthermore, Malaysia's global hub status in Islamic finance is attributed to top institutions like INCEIF, ISRA, IIBF, and INHARA, which provide high-quality education and maintain a steady supply of skilled human capital (Zafar & Jafar, 2024). Malaysia's Islamic finance sector is thriving through government incentives, technological advancements, public awareness, and financial literacy programs. Risk management and resilience are crucial for success, ensuring stability during economic downturns. Among the factors are the ability to access the global market, participation of local and international investors, use of local and foreign currencies, strong interbank money market and a variety of financial instruments (IFSB, 2024). Finally, Islamic banks contribute to community welfare and Malaysia's position in the global Islamic finance market is further enhanced by international partnerships and foreign investments.

3. Research Methodology

This study adopts a qualitative literature review approach, drawing on published academic works, legal documents, industry reports, official records, and relevant websites, and employs comparative and content analysis to examine the systems of Malaysia and Afghanistan.

Adopting the establishment of an Islamic bank in Afghanistan, inspired by the Malaysian experience, is expected to drive significant changes in the Islamic financial system and contribute to the country's economic

development. This paper explores the implementation of an Islamic banking system in Afghanistan, drawing inspiration from the successful Malaysian experience. In Afghanistan, the banking sector plays a crucial role in the country's economic development. Since 99% of the population being Muslim, Islamic banking is expected to gain significant trust, whereas currently only 7.5% of the population uses banking services, mostly concentrated in a few cities like Kabul (Disli et al., 2023a). Afghanistan's banking system, rebuilt post-2001 with international support, now has around 12 banks, including one full-fledged Islamic bank, up from 3 state banks before 2001. This expansion is expected to encourage more people to deposit money and take loans (Centre for Strategic and Regional Studies, 2022).

3.1 Leveraging Malaysia's Islamic Banking Model For Afghanistan's Financial Transformation:

Malaysia's Islamic finance hub serves as a model for Afghanistan, offering Shariah-compliant financial systems. Adopting Malaysia's Islamic banking framework could help Afghanistan establish a stable, inclusive financial sector. Malaysia's Islamic banking promotes financial inclusion through microfinance, aiding poverty reduction. Malaysia integrates Zakat and Waqf into its financial system, funding social welfare initiatives in sectors like healthcare, infrastructure, and education (Seyd Othman & Aljunid, 2017). Malaysia's integration of Islamic banking elements promotes social justice and well-being by developing tailored financial products for diverse groups, including refugees. The country has used Sukuk to fund infrastructure projects, showcasing Islamic finance's potential for large-scale development. The dual-banking system expands service offerings and aligns financial growth with environmental goals through Islamic green financing initiatives (Uddin et al., 2024). Islamic banking in Malaysia has grown significantly through efforts to promote financial inclusion for women and establish a high-quality financial index. The country has also advanced digital banking, enabling rural communities to access services through mobile platforms. Islamic finance initiatives have supported the agricultural sector, mitigated risks for small enterprises, and aided post-conflict economic reconstruction. Regional cooperation and global collaboration have reinforced Malaysia's leadership in international Islamic finance (Latip, 2024). Additionally, Islamic trade finance has expanded export markets, while investments in education and training have created a skilled workforce, ensuring sector growth. Based on the success Malaysia's experience, Afghanistan could benefit from Malaysia's Islamic banking system, focusing on small-scale, Shariah-compliant funding for low-income and rural entrepreneurs. This could improve social development financing and facilitate integration for internally displaced persons, inspired by Malaysia's approach. Furthermore, Afghanistan could fund infrastructure projects with Islamic principles by issuing Sukuk, adopting a dual-banking system like Malaysia, and green Islamic finance products to address environmental issues. Shariah-compliant banking services could empower women, such as microloans and financial support for female entrepreneurs. Also, Afghan Islamic Banking Index, inspired by Malaysia's models, could track sector growth and guide policy decisions. Malaysia's experience suggests that digital and mobile banking solutions can enhance financial inclusion, especially in remote areas. Digitalized payment services include ATMs, CDMs, E-Debit, MEPS, Interbank GIRO, FPX, internet banking, phone and mobile banking, SMS banking, PENTAS, SWIFT, and Islamic interbank (Dusuki & Abdullah, 2011). Additionally, Islamic agricultural financing and Takaful products through Islamic banking can improve risk management and productivity in sectors like agriculture, healthcare, and small businesses, while also aiding Afghanistan's post-conflict reconstruction through Shariah-compliant finance. Islamic trade finance can support Afghan exports in artisanal and agricultural sectors. Developing human capital through specialized training and global collaborations is crucial for driving Islamic finance growth. Regional cooperation with Malaysia can enhance Afghanistan's Islamic banking system through knowledge exchange and joint projects. So, by adopting Malaysia's successful Islamic banking model, Afghanistan can establish a robust, ethical banking system that meets local financial needs, supports national economic stability, and adheres to Islamic principles (Uddin et al., 2024).

3.2 Challenges And Opportunities For Islamic Banks In Afghanistan

The establishment of Islamic banks in Afghanistan presents both significant challenges and opportunities.

3.2.1 Challenges

A major challenge is the lack of infrastructure, Afghanistan's underdeveloped banking sector lacks the physical and digital infrastructure needed for modern banking, including Islamic finance (Disli et al., 2023b). Another

key issue is the absence of a regulatory framework, and without comprehensive laws to support Sharia-compliant banking, it is difficult for Islamic banks to operate effectively. Political instability also poses a significant barrier, as conflict and uncertainty hinder economic development and investor confidence (Naseri, 2020). The shortage of qualified professionals in Islamic finance further complicates the situation, requiring specialized training programs. Additionally, public awareness of Islamic banking is low, which could hinder adoption. Lastly, economic instability, with a large portion of the population living below the poverty line, makes it challenging for many to engage with Islamic banks (Alami et al., 2021).

3.2.2 Opportunities

Despite these challenges, Afghanistan offers several opportunities for Islamic banking. As a predominantly Muslim country, the population is likely to embrace a financial system that aligns with their cultural and religious values. Financial inclusion is a key opportunity, as Islamic banks could provide Sharia-compliant microfinance products to underserved populations, particularly in rural areas (Disli et al., 2023a). Islamic banking can also support social and economic development through Zakat and Waqf, funding projects in healthcare, education, and infrastructure. Additionally, the development of Islamic capital markets, such as Sukuk (Islamic bonds), could provide a means for raising funds for infrastructure projects. Regional collaboration with Islamic financial hubs like Malaysia could offer expertise and investment, while international support from global Islamic finance communities could further strengthen the sector (Naseri, 2020). As a result, while Afghanistan faces challenges like lack of infrastructure, political instability, and limited human capital, there are substantial opportunities for developing a robust Islamic banking system (Zafar & Jafar, 2024). By aligning with cultural values, promoting financial inclusion, and fostering social development, Afghanistan can leverage these opportunities to build a successful and inclusive Islamic banking system (Uddin et al., 2024). On the other hand, Afghanistan can successfully transition from conventional banking to Islamic banking with technical support from international institutions like the World Bank, IDB, IMF, and regional partners like Gulf countries and Malaysia. Key players in this process include the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), which has 45 member countries, and works to harmonize and standardize Islamic financial and reporting practices globally, and the Islamic Financial Services Board (IFSB) in Malaysia with 57 member countries, which promotes the stability and resilience of the Islamic financial services industry (Abozaid & Khateeb, 2024). Through collaboration with these institutions, Afghanistan can develop a comprehensive legal infrastructure, improve information technology and banking systems, and establish robust supervisory and enforcement frameworks necessary for the successful implementation of Islamic banking.

4. Findings

The study reveals that Malaysia offers valuable insights and ideal model for developing a sustainable Islamic banking system in Afghanistan. Key factors contributing to Malaysia's success include a comprehensive legal and regulatory framework that ensures Shariah compliance and financial stability, coupled with strong governmental support that fosters policy continuity and sector growth. High levels of public awareness and trust in Islamic finance have facilitated widespread adoption of Shariah-compliant products, while the availability of diverse and inclusive financial instruments meets the interests of both individual and corporate clients. Moreover, Malaysia's emphasis on sustainability, risk management, and innovation has fostered resilience and adaptability within its Islamic finance industry. These factors collectively highlight the significance of an integrated strategy that combines regulatory rigor, institutional support, market awareness, and product innovation—in establishing a comprehensive benchmark for developing resilient, competitive, robust and sustainable Islamic banking system in Afghanistan. Additionally, the mechanism of adapting Malaysia's Islamic finance framework to Afghanistan requires establishing a comprehensive legal and regulatory infrastructure for Islamic finance within Afghanistan's existing Sharia court system, strengthening Sharia governance through the establishment a national Sharia Advisory Council (SAC), integrating international standards, and the encouragement of innovation through collaborative efforts with Afghan financial institutions and international bodies. Malaysia's dual financial system and its well-established Shariah governance model provide a practical blueprint for Afghanistan, enabling to enhance financial inclusion,

support SME growth, and advance general financial stability while guaranteeing adherence to the Shariah principles.

5. Conclusion

In conclusion, there are many opportunities and challenges to building a sustainable Islamic banking system in Afghanistan. By drawing insights from Malaysia's successful model, Afghanistan can potentially navigate these obstacles, and overcome these challenges, leveraging Malaysia's expertise in regulatory frameworks, shariah governance, financial innovation, and integration of Islamic principles with modern banking practices. Important takeaways include the significance of establishing a strong legal and regulatory framework, promoting financial literacy, and supporting an enabling environment that is conducive to Islamic financial products. Although Afghanistan's distinct socio-political and economic context requires customized solutions, Malaysia's experience shows that a sustainable Islamic banking system can be established with careful planning, collaboration, and a commitment to financial inclusivity, supporting Afghanistan's financial stability and economic growth.

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Distribution of *Zakāt* to Non-Muslims in the Category of *Al-Mu'allafah Qulūbuhum* and Its Application in Modern Time

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Abstract

This study undertakes a critical analysis of scholarly discourse surrounding the disbursement of zakāt to non-Muslims categorized as *al-Mu'allafah Qulūbuhum* (those whose hearts are reconciled). It comparatively examines diverse interpretations from both classical and contemporary *fuqahā'*. By doing so, the research aims to illuminate the contemporary applications of zakāt disbursement to non-Muslims within the Malaysian context. This study employs an exploratory qualitative approach to comprehensively review the diverse perspectives of jurists across the four principal Sunni *madhāhib*: the Ḥanafīyyah, Mālikīyyah, Shāfi'īyah, and Ḥanbaliyyah schools, contemporary *fiqh al-wāqī'* perspectives and their application within Malaysian context. This study relies on secondary data derived from a comprehensive review of relevant academic publications, including classical and contemporary manuscripts, journal articles, and research papers, as well as professional resources such as websites, official documents, and reports. Furthermore, the central focus is the intricate issue of zakāt distribution to non-Muslims under the *al-Mu'allafah Qulūbuhum* category, with particular emphasis on its applicability in modern contexts. The findings reveal that zakāt funds can be allocated to non-Muslims categorized as *al-Mu'allafah Qulūbuhum* for public interest (*maṣlahah*), specifically to foster interfaith relations and support *da'wah* efforts either through *tamlīk al-a'yān* (outright ownership) or *tamlīk al-manfa'ah* (beneficial ownership), whether *mubāshir* (direct) or *ghayr mubāshir* (indirect). This permissible allocation, supported by Sharī'ah experts and some State Islamic Religious Councils (SIRCs), highlights an approach where zakāt's reach extends beyond direct Muslim beneficiaries under specific conditions to prevent discord, thereby exemplifying its holistic impact as a tool for socio-economic well-being. This study offers an evidence-based understanding of the distribution of zakāt to *al-mu'allafah qulūbuhum* in its contemporary Malaysian context, thereby contributing meaningfully to the academic discourse and practical policy development in zakāt management.

Keywords: *Zakāt, al-Mu'allafah Qulūbuhum, the Ḥanafīyyah, Mālikīyyah, Shāfi'īyah, Ḥanbaliyyah schools, State Islamic Religious Councils (SIRCs), tamlīk al-a'yān (outright ownership), tamlīk al-manfa'ah (beneficial ownership), Malaysia*

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1. Introduction

Though Qur'ān clearly mentioned the recipients (*maṣārīf*) of zakāt, jurists have difference opinions in the application of *al-Mu'allafah Qulūbuhum*, which is one of the *Maṣraf* as mentioned in Qur'ān (Al-Zayl'aī, 1895; Al-Kāsānī, 1986; Ibn al-Humām, 1970; Al-Maydānī n.d; Al-Bābartī, 1971). According to various scholars, *Mu'alaf al-Qulūb* were a group of leaders from the Quraysh and prominent figures among the Arabs, such as Abū Ṣufyān ibn Harb, Safwān ibn Umayyah, Al-Aqr'a ibn Ḥābis, 'Uyaynah ibn Ḥiṣn al-Fazārī, 'Abbās ibn

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Murādis al-Sulamī, Mālik ibn ‘Auf al-Nasri, Ḥakīm ibn Hizām, and others (Al-Kāsānī, 1986; Ibn al-Humām, 1970 & Al-Bābartī, 1971). They had influence, power and huge number of followers. Some of them embraced Islam sincerely, while others pretended to embrace it without sincerity. Some were hypocrites, and some were peaceful (Al-Kāsānī, 1986; Ibn al-Humām, 1970; Al-Bābartī, 1971). According to some scholars, they were divided into three categories, a) those to whom the Prophet (ﷺ) made allocation in order to foster unity in Islam, b) those to whom the Prophet (ﷺ) made allocation in order to mitigate potential harm, and c) those who embraced Islam, among whom were those weak in their faith, He (ﷺ) gave to them to fortify their faith in Islam (Ibn Nujaym, 1997; Al-Maydānī, 2014; Ibn al-Humām, 1970; Al-Bābartī, 1971).

The Prophet (ﷺ) employed the distribution of zakāt funds as a strategic instrument for consolidating the hearts of the Muslims among them, affirming them in Islam, encouraging their followers to follow them, and reconciling those whose Islam was not genuine. The Prophet’s (ﷺ) exemplary conduct and benevolent treatment facilitated the conversion of many to Islam (Al-Kāsānī, 1986; Ibn Nujaym, 1997; Al-Maydānī, 2014; Ibn al-Humām, 1970; Al-Bābartī, 1971). It is narrated that Ṣafwān ibn ‘Umayyah in Al-Tirmizī (2016), he said, “The Prophet (ﷺ) gave me, despite my being the most hated person to him. His consistent generosity made him the most beloved person to me”.

However, there was a difference of opinion regarding their shares after the demise of the Prophet (ﷺ). The majority of scholars assert that their shares ceased to exist, and they did not receive anything after the Prophet’s (ﷺ) death. According to one view attributed to Imām Al-Shāfi‘ī, their entitlements were cancelled entirely. Another perspective, also attributed to Imām Al-Shāfi‘ī, maintains that their rights continued, and what remained of their shares was distributed among those who remained faithful during the Prophet’s (ﷺ) lifetime. The correct opinion, supported by the consensus of the Companions, is that neither Abu Bakr (R.A) nor ‘Umar (R.A) gave anything from the charity to them, and none of the Companions objected to this (Al-Kāsānī, 1986).

In this regard, it is narrated that when the Prophet (ﷺ) passed away, some individuals approached Abu Bakr (R.A) and requested to exchange their shares for land. Abu Bakr (R.A) consented to their request and facilitated the exchange. Later, these individuals approached ‘Umar (R.A) and informed him of what occurred. ‘Umar took the deeds and tore them, stating that the Prophet (ﷺ) used to grant them as a means of fostering unity among them in Islam. However, Islam was now firmly established, and if they remained steadfast, it would be sufficient; otherwise, the only recourse would be the sword. These people went back to Abu Bakr (R.A) and informed him of ‘Umar’s actions. Abu Bakr (R.A) did not dispute Umar’s words or actions, and this news reached the companions, who did not object, thus forming a consensus among them (Al-Kāsānī, 1986; Ibn al-Humām, 1970 & Al-Bābartī, 1971).

Additionally, it is established unanimously by the Muslim scholars that the Prophet (ﷺ) granted *al-Mu'allafah Qulūbuhum* as a means of fostering unity in Islam. At that time, Islam was weak, and its followers were few, while those people possessed strength and numbers. Later, Islam has gained strength, its followers have multiplied, its foundations have been solidified, and the polytheists have been humiliated. Since their entitlement to zakāt was contingent upon a specific cause (*'illah*), their share will cease upon the cessation of that cause (Al-Kāsānī, 1986; Ibn al-Humām, 1970 & Al-Bābartī, 1971).

Similarly, many of the polytheists had agreements with the Prophet (ﷺ) due to his need for treaties and engagements with them, given the scarcity and weakness of the Muslims at that time. However, when Allah (جل جلاله) honoured Islam and its followers multiplied, the Prophet (ﷺ) was commanded to honour the agreements made with the polytheists and to engage in warfare against them collectively (Al-Kāsānī, 1986). This command is articulated in the Qur’ān (9:1), from the verse: “A declaration of immunity from Allah and His Messenger to those of the polytheists with whom you had made agreements” to the verse (9:5): “So when the sacred months have passed away, then slay the polytheists wherever you find them”.

According to al-Ḥaṣkafī (2002), their entitlement from the zakāt fund is terminated either due to the termination of (*'illah*), or due to the ḥadīth of the Prophet (ﷺ) to Mu‘ādh bin Jabal: “Allah has made it obligatory for them to pay zakāt upon their assets and it is to be taken from the wealthy among them and given to the poor among them”. This ḥadīth (Al-Bukhārī, 1981) elucidates that zakāt will be collected solely from eligible Muslims and distributed among them, thus excluding the inclusion of non-Muslims in the allocation of zakāt funds.

A comprehensive analysis of the inclusion of both Muslims and non-Muslims within the *al-mu'allafah qulūbuhum* category will be discussed in the subsequent discussion from classical *fiqh* analysis.

2. Literature Review

2.1 The Concept of *al-Mu'allafah Qulūbuhum* According to the Classical scholars

Jurisprudential scholars, representing diverse *madhāhib*, have engaged in extensive discourse concerning the conceptualization and definition of *al-Mu'allafah Qulūbuhum*, as well as the ongoing relevance of this category within contemporary Islamic legal discourse. The following represents the positions articulated by the four established schools of jurisprudence.

2.1.1 The *Ḥanafī* School of Jurisprudence

The *Ḥanafī* jurisprudence (Al-Qarāfī, 1994) posits the obsolescence of the *al-Mu'allafah Qulūbuhum* category within contemporary legal discourse, asserting its historical contingency tied to the era of the Prophet Muhammad (ﷺ). However, Al-Kāsānī in his book *Badā'ī 'al-Ṣanā'ī* reported two opposite opinions, with one aligning with the great students of Imām Abū Ḥanīfah while the other one is aligning with the majority of the scholars that maintained the existence of *al-Mu'allafah Qulūbuhum* if the 'illah is existence (Al-Māwardī, 1994; Ibn Qudāmah, 1968; Ibn Taymiyyah, 1995). Al-Zayla'ī, on the other hand, profoundly clarified that though the *al-Mu'allafah Qulūbuhum* had ceased to exist by the demise of the Prophet (ﷺ) but he unequivocally underscored that the inexistence is not coming from any abrogation because there is no abrogation after the demise of the Prophet (ﷺ) (Ibn Qudāmah, 1968).

2.1.2 The *Mālikī* School of Jurisprudence

The *Mālikī* school posited that the category of *al-Mu'allafah Qulūbuhum* was no longer applicable due to the perceived consolidation and ascendance of Islam. However, in Ibn 'Abd al-Barr al-Qurṭubī (1980); Al-Jallāb al-Mālikī (2007); Ibn Rushd (2004); Abū Bakr Ibn Al-'Arabī (2003); Ibn 'Abd al-Barr al-Qurṭubī (2000); and Al-Qarāfī (1994), the *Imām* retains the discretionary authority to allocate funds from this category to non-Muslims whose support could benefit Islam or who pose potential threats, should he deem it judicious. Al-Jazīrī (2003), a distinguished scholar of the *Mālikī* school of thought, contends that the permissibility of providing zakāt to non-Muslim spies aligns with the concept of *maṣlahah*, which prioritizes the preservation of the Muslim community's well-being, including the protection of life (*ḥifẓ al-naḥs*) and property (*ḥifẓ al-māl*). However, such a decision necessitates a careful examination of the specific circumstances, the underlying intentions, and the potential *maṣlahah* to the Muslim community.

2.1.3 The *Shāfi'ī* School of Jurisprudence

The *Shāfi'ī* jurist, Al-Shīrāzī, posited that the category of *al-Mu'allafah Qulūbuhum* comprises two distinct classifications: Muslims and non-Muslims. He further delineates two divergent *Shāfi'ī* opinions concerning the permissibility of allocating zakāt to non-Muslims within this category. The first opinion denies their entitlement, while the second permits it, positing that the conditions justifying such disbursements during the Prophet's (ﷺ) era may persist. Al-Shīrāzī (2003), however, concludes that even if the latter, more permissive, view is adopted, the requisite funds should be drawn from public welfare endowments (*bayt al-māl*) rather than from the obligatory zakāt levy. The *al-Mu'allafah Qulūbuhum* (those whose hearts are to be reconciled) are those who have entered Islam, and a polytheist is not given from charity to reconcile them to Islam. If someone says, 'The Prophet (ﷺ) gave some of the *al-Mu'allafah Qulūbuhum* among the polytheists gifts during the year of Hunayn, the response is that he gave them from the *ḥay'* (war spoils) and from his personal wealth, not from the charity funds. It is permissible for him to give from his own wealth (Al-Shāfi'ī, 1983).

The *Shāfi'ī* school of Islamic jurisprudence predominantly adheres to the view that zakāt, a mandatory form of charity in Islam, is not to be disbursed to non-Muslims. This perspective is corroborated by Imām al-Juwaynī, who conveyed this stance as representative of the *Shāfi'ī* school and further substantiated by the author of Al-Mughnī, who posited that there is a consensus (*ijmā'*) on this matter within the school.¹ This assertion of consensus, however, is challenged by al-Māwardī, who contends that non-Muslims categorized as *al-Mu'allafah Qulūbuhum* may, in fact, be eligible for zakāt disbursements (Al-Sharbinī, 1997; Al-Juwaynī, 2007; Al-Māwardī, 1994).

The *Shāfi'ī* jurist, Al-Māwardī, posited that the default recipients of zakāt / *ṣadaqah* are the indigent (the poor and needy). However, he further categorized these recipients into two distinct groups: those eligible for

¹ The consensus (*ijmā'*) referenced here is circumscribed within the *Shāfi'ī* madhhab and is subject to refutation by certain adherents of that very school (e.g. *Mughnī al-Muhtāj*, vol. 4, p. 178).

zakāt due to their impoverished state, and those whose circumstances necessitate provision irrespective of their financial standing. The latter category, according to Al-Māwardī (1994), includes, for example, zakāt administrators and the *al-Mu'allafah Qulūbuhum*, who are given not on the basis of poverty or wealth, but rather due to other considerations. Al-Māwardī argued that the correct view is that Allah designated zakāt for two purposes i.e. to fulfill the needs of the Muslims; and to bolster the strength and propagation of Islam. For anything that serves to support Islam, both affluent (rich) and indigent individuals may receive, such as those engaged in *jihād* and analogous endeavors. This is also the basis for giving to *al-Mu'allafah Qulūbuhum* (those whose hearts are to be reconciled). As for charity intended to meet the needs of Muslims, it is given accordingly.

Imām Al-Muzanī in *Mukhtaṣar al-Muzanī fī Furū' al-Shāfi'īyyah* reported the two Madhhab of the *al-Qadīm* and *al-Jadīd* saying that in his *Madhhab al-Qadīm*, Imām Shāfi'ī approved giving to both new convert and the non-Muslims. However, Imām Shāfi'ī in his *Madhhab al-Jadīd* posited that the category of *al-Mu'allafah Qulūbuhum* eligible for zakāt disbursement is strictly limited to new converts to Islam, a view concordant with that of Imām Mālik. Furthermore, while acknowledging the permissibility of supporting non-Muslims for the purpose of reconciliation, Imām Shāfi'ī maintained that such support must be derived from sources other than zakāt funds, citing the Prophet's (ﷺ) actions at the Battle of Hunayn as precedent. Thus, in Imām Shāfi'ī's considered opinion, non-Muslims, though potentially falling under the general rubric of *al-Mu'allafah Qulūbuhum*, are categorically excluded from receiving zakāt (Al-Shāfi'ī, 1983). Imām Shāfi'ī's justification for this position rests on the assertion that the precedent of allocating *zakāt* funds to non-Muslims ceased during the caliphate of Sayyidīnā 'Abū Bakr. This discontinuation was subsequently upheld by his successors, 'Umar, 'Uthmān, and 'Alī, who did not reinstate the practice (Al-Muzanī, 2019).

2.1.4 The Ḥanbalī School of Jurisprudence

Within the Ḥanbalī School of Jurisprudence (Ibn Qudāmah, 1968; Al-Māwardī, 1994), there exist two divergent positions on this matter.

The First Opinion:

The classification of *al-Mu'allafah Qulūbuhum* retains its contemporary relevance as a legitimate recipient category of zakāt, contingent upon the ascertainment by qualified Muslim authorities that the underlying rationale for its original designation during the Prophet's (ﷺ) time remains applicable. Proponents of this position adduce the following evidentiary supports: (1) The Prophetic (ﷺ) precedent, constituting a direct implementation of the Qur'anic verse (9:60); (2) The unabrogated (*naskh*)² and thus subsisting validity of the apportioned share for this category within the aforementioned verse.

The eminent Ḥanbalī jurist, Al-Bahūtī (1636) asserted in his writing that the extension of zakāt to non-Muslims in time of need, is permissible.³

The Second Opinion:

The category of *al-Mu'allafah Qulūbuhum* has ceased to exist. This position is supported by the following evidentiary arguments:

- i. Allah, in His divine wisdom, has bestowed upon Islam and its adherents such strength, fortitude and ascendancy that the winning over of a polytheist through material wealth is rendered unnecessary.
- ii. The argument posits that the Prophet's (ﷺ) policy of conciliating hearts (*al-Mu'allafah Qulūbuhum*) was contextually contingent, arising from a position of relative weakness when the Muslim community was numerically smaller than the non-Muslim population, or because he would give them from his own wealth which Allah had granted him, specifically from his personal share of the booties (*fay'*) over which he had full discretion to use as deemed appropriate.

2.2 The Categories of Muslims and Non-Muslims Eligible for *Al-Mu'allafah Qulūbuhum* from The Classical Fiqh Analysis

Some jurists (Al-Māwardī, 1994; Ibn Qudāmah, 1968; Ibn Taymiyyah, 1995) have posited that the category of

² *Naskh* means replace or revoke the divine law prescribed by Allah (SWT) with a stronger subsequent revelation or as strong as it is, i.e. the abrogation or supersession of a previous divine law or ruling by a subsequent one. Hence, the discussion necessitates the continued application of the *mu'allaf* interpretation.

³ يُعْطَوْنَ عِنْدَ الْحَاجَةِ، وَيُحْمَلُ تَرْكُ عَمْرٍ وَعُثْمَانَ وَعَلِيٍّ إِعْطَانَهُمْ عَلَى عَدَمِ الْحَاجَةِ إِلَى إِعْطَانِهِمْ فِي خِلَافَتِهِمْ، لَئِيسُفُوطَ سَنِهِمْ،

They are given when needed, and the refraining of 'Umar, 'Uthmān, and 'Alī from giving should be understood as a lack of need during their caliphates, not as a cancellation of their share (Al-Buhūtī, 1636; Al-Zuhaylī, 1985).

al-Mu'allafah Qulūbuhum encompasses both Muslims and non-Muslims.

The non-Muslim category is divided into the following two subtypes:

- i. Non-Muslims who are hoped to embrace Islam and they are given gifts (*ta'lif al-qulūb*) aimed at softening hearts and fostering receptivity towards the message of Islam.
- ii. For example, on the day of the Conquest of Mekah, the Prophet (ﷺ) granted protection to Ṣafwān ibn Umayyah. Safwan asked for a four-month period to consider his stance, and he accompanied the Prophet (ﷺ) to the Battle of Hunayn. When the Prophet (ﷺ) distributed gifts, Ṣafwān asked, "What is there for me?" The Prophet (ﷺ) pointed to a valley filled with loaded camels and said, "This is for you." Ṣafwān then said, "This is the gift of one who does not fear poverty." (Ibn Qudāmah, 1968). He was offered security by the Prophet (ﷺ) during the Conquest of Mekah (Ibn Kathīr, 1969), who eventually became a faithful Muslim.
- iii. Non-Muslims who perceived as a threat to Muslims, and by disbursing them zakāt would prevent them from performing any evil, abusive and harmful acts towards Muslim. Ibn 'Abas narrates that certain people came to the Prophet (ﷺ) and declared that if they were given *ṣadaqah*, they would praise Islam and declare it as good religion; otherwise, they denounced Islam" (Al-Ṭabarī, n.d).

On the the other hand, the designation of *al-Mu'allafah Qulūbuhum* among Muslims is further delineated into four subcategories (Al-Ṭabarī, n.d):

- i. A group of influential Muslim figures who have counterparts among the non-Muslims, or Muslims with sincere intentions toward Islam. If they are given zakāt, it is hoped that their non-Muslim counterparts will embrace Islam and that their good intentions will be reinforced. The permissibility of such an allocation is thus substantiated. This practice finds precedent in the actions of prominent figure such as Abū Bakr al-Siddīq (may Allah be pleased with him), who extended gifts to individuals like 'Adī ibn Ḥātim and Al-Zibraqān ibn Badr, acknowledging their bona fide intentions and adherence to Islam.
- ii. Leaders who are obeyed by their people, when such allocation serves to fortify their *īmān* and bolster their loyalty to *jihad*. This is evidenced in the following ḥadīth:
 - a. The Prophet (ﷺ) gave to 'Uyaynah ibn Ḥiṣn, Al-'Aqra' ibn Ḥābis, Alqāmah ibn Ulathah, and the "freed ones" among the people of Mekah. He said to the Ansar, "O Ansar, why are you disheartened? Over a small share of worldly things, I have sought to reconcile others because there is no faith in their hearts, and I have entrusted you to your own faith?"
 - b. Al-Bukhārī narrated, with his chain of transmission, from 'Amr ibn Taghlib that the Messenger of Allah (ﷺ) gave to some people and left out others. When he learned that those who were left out were displeased, he ascended the pulpit, praised Allah, and said, "Indeed, I give to some and leave out others. Those I leave out are dearer to me than those to whom I give. I give to some because of their distress and fear, while I leave others due to the richness and goodness in their hearts, including 'Amr ibn Taghlib."
 - c. Anas narrated that, when Allah granted the Prophet (ﷺ) the spoils of Hawazin, he began to give a hundred camels each to men from Quraysh. Some of the Ansar said, "May Allah forgive the Messenger of Allah; he gives to Quraysh and withholds from us, while our swords still drip with their blood." The Prophet (ﷺ) responded, "I give to men who are [newly committed] to Islam, hoping to win their hearts." This ḥadīth is agreed upon.
- iii. A category of a group living on the borderlands of the Islamic territories who, if given support, can protect neighboring Muslims.
- iv. The fourth type is a group who, when given, encourage others to pay zakāt particularly those who would otherwise only pay it out of fear.

Ibn Qudāmah said that it is permissible to give zakāt to all the above listed categories, as they fall under *al-Mu'allafah Qulūbuhum* that is in the general scope of the verse.

From the aforementioned discourse of classical jurists, it can be summarized that during the time of the Prophet (ﷺ), *al-Mu'allafah Qulūbuhum* were granted their share from the zakāt fund due to the reasons mentioned above. However, after the demise of the Prophet (ﷺ) their share was terminated as the specific causes mentioned no longer apply, and there is a consensus of the Companion on this matter. Notably, various classical scholars mentioned that the share of *al-Mu'allafah Qulūbuhum* was terminated due to the termination of its

cause. This aligns with the fundamental principle of *uṣūl al-fiqh*⁴ which stipulates the legal ruling is intrinsically linked to its underlying cause (*illah*), manifesting and receding in tandem with the presence or absence of the *illah* itself. The majority of jurists maintain that *illah* for giving zakāt to *al-Mu'allafah Qulūbuhum* is no longer applicable. Consequently, the allocation of zakāt to them should also cease. Thus, a ruling is concomitantly revolving with its *illah*, where the *illah* appears its appear and where the *illah* disappears the ruling also disappear (Al-Jawziyyah, 1991).

2.3 Concluding Remarks on The Distribution of Zakāt to Non-Muslims in The Category of Al-Mu'allafah Qulūbuhum According to The Classical Scholars

A scholarly investigation of classical *fiqh* texts reveals a complex discourse among *fuqahā'* regarding *al-Mu'allafah Qulūbuhum*, specifically concerning the eligibility of non-Muslims for zakāt funds. This necessitates a rigorous analysis of the diverse methodologies and *uṣūl al-fiqh* across *madhāhib* to define the precise scope of this eligibility within Islamic jurisprudence.

Having discussed the abovementioned concept of *al-Mu'allafah Qulūbuhum*, Ḥanafī jurisprudence generally deems the *al-Mu'allafah Qulūbuhum* category obsolete, though some early Ḥanafī scholars disagreed (Al-Māwardī, 1994; Ibn Qudāmah, 1968; Ibn Taymiyyah, 1995), citing its continued relevance if the underlying rationale persists. This perspective finds resonance in Mālikī jurisprudence, who positing the obsolescence of the *al-mu'allafah qulūbuhum*, yet permits discretionary allocation to non-Muslims for strategic Islamic benefit or potential threats mitigation (Ibn 'Abd al-Barr al-Qurṭubī, 1980; Al-Jallāb al-Mālikī, 2007; Ibn Rushd, 2004; Abū Bakr Ibn Al-'Arabī, 2003; Ibn 'Abd al-Barr, 2000; Al-Qarāfī, 1994). Within the Shāfi'ī school, zakāt disbursement to non-Muslims in *al-Mu'allafah Qulūbuhum* is a matter of scholarly contention. While prominent Shāfi'ī jurists such as Al-Shīrāzī, Al-Juwaynī and Al-Sharbīnī⁵ posit a consensus within the school against such disbursement, al-Māwardī (Al-Sharbīnī, 1997; Al-Juwaynī, 2007), contests this, advocating for the potential eligibility of non-Muslims within this category. Even those who permit it, like Al-Shīrāzī (1995), recommend prioritizing alternative funding sources, such as the *bayt al-māl* (public treasury), over the utilization of zakāt funds for this purpose. The Ḥanbalī school presents two views on *al-Mu'allafah Qulūbuhum*. The first maintains its zakāt eligibility if contemporary conditions mirror the Prophet's (ﷺ) era, citing prophetic precedent and the verse's unabrogated nature. Al-Bahūtī (1636) allowed the extension of zakāt to non-Muslims under conditions of compelling necessity.⁶ The second argues its obsolescence, positing Islam current strength negates the need for such inducement, and that the Prophet's (ﷺ) actions were context-specific, related to early Islam relative weakness or his discretionary use of *fay'* (Ibn Qudāmah, 1968).

Suffice to say, regarding the *al-mu'allafah qulūbuhum* category in Islamic jurisprudence, two primary opinions exist. The first posits its continued relevance, arguing that the category remains applicable if the original rationale (Al-Māwardī, 1994; Ibn Qudāmah, 1968; Ibn Taymiyyah, 1995) i.e. strengthening Islam or mitigating potential threats persists (Ibn 'Abd al-Barr al-Qurṭubī, 1980; Al-Jallāb al-Mālikī, 2007; Ibn Rushd, 2004; Abū Bakr Ibn Al-'Arabī, 2003; Ibn 'Abd al-Barr, 2000; Al-Qarāfī, 1994). This view, while prominent in Ḥanbalī jurisprudence and echoed by some Ḥanafī and Mālikī scholars, emphasizes the unabrogated nature of the relevant Qur'anic verse and prophetic precedent. The second opinion deems the category obsolete, asserting that the changed socio-political landscape of Islam negates the need for such inducements. This perspective, dominant in Ḥanafī and Mālikī schools, and constituting a substantive viewpoint within the Ḥanbalī school, contends that the Prophet's (ﷺ) actions were context-specific, specifically related to the nascent Islamic community's relative vulnerability or his discretionary deployment of *fay'* resources. Within the Shāfi'ī school, while the prevailing view opposes zakāt disbursement to *al-mu'allafah qulūbuhum*, a minority opinion, notably championed by al-Māwardī, allows it under specific circumstances.

⁴ "أَلْحَكْمُ يَدُورُ مَعَ عِلَّتِهِ وَوُجُودًا وَعَدَمًا" "A legal ruling is contingent upon its underlying cause, existing when the cause exists and ceasing when the cause is absent" Al-Jawziyyah, (1991).

⁵ The consensus (*ijmā'*) referenced here is circumscribed within the Shāfi'ī madhhab and is subject to refutation by certain adherents of that very school (e.g. *Mughnī al-Muhtāj*, vol. 4, p. 178).

⁶ يُعْطَوْنَ عِنْدَ الْحَاجَةِ، وَيُحْمَلُ تَرْكُ عَمْرِ وَعَثْمَانَ وَعَلِيٍّ إِعْطَانُهُمْ عَلَى عَدَمِ الْحَاجَةِ إِلَى إِعْطَانِهِمْ فِي خِلَافَتِهِمْ، لَئِيسُفُوطِ سَهْمِهِمْ،

They are given when needed, and the refraining of 'Umar, 'Uthmān, and 'Alī from giving should be understood as a lack of need during their caliphates, not as a cancellation of their share (Al-Buhūtī, 1636; Al-Zuhaylī, 1985).

3. Research Methodology

This study critically scrutinizes classical and contemporary interpretations of *al-Mu'allafah Qulūbuhum*, through a meticulous comparative analysis encompassing the four principal Sunni *madhāhib* and a range of scholarly and institutional perspectives. The study aims to furnish a comprehensive understanding of the term, its practical implications, and its continued relevance to the disbursement of zakāt to non-Muslims designated in the modern context.

3.1. Research Design

The research design helps the researchers to select the technique for collecting and analyzing the data according to the type of study. For managing the current research, the researchers have selected a qualitative research design employing an exploratory approach. This design facilitates the exploration of the distribution of zakāt to non-Muslims in the category of *al-mu'allafah qulūbuhum* and its application in modern time, enabling a comprehensive understanding of the discussion.

By undertaking an in-depth exploration, this study endeavours to critically examine the historical jurisprudential interpretations and contemporary *fiqh al-wāqi'* perspectives, and the applications of zakāt distribution to non-Muslim recipients under the category of *al-mu'allafah qulūbuhum*. Specifically, the study seeks to unpack the underlying rationales, conditions, and potential implications of extending zakāt funds to non-Muslims in modern contexts, thereby contributing to a richer understanding of zakāt's socio-economic and *da'wah* purposes.

3.2 Data Collection

The data collection process consists primarily of secondary data on the distribution of zakāt to non-Muslims falling under the category of *al-mu'allafah qulūbuhum* and its contemporary application. As researchers consider the integration of secondary data into the research, its appropriate selection is fundamental to bolstering the reliability and validity of study's findings. This necessitates a careful evaluation based on several key criteria. [Dudovskiy \(2018\)](#) explains that researchers must assess the credibility of the source, the recency of the publication, the expertise of the author, the thoroughness of the analysis presented, the persuasiveness of the discussion, and ultimately, how significantly the data contributes to the research area development. Therefore, the data in the study are sourced from relevant academic publications, including classical and contemporary manuscripts, journal articles, and research papers, as well as professional resources such as websites, official documents, and reports. This comprehensive approach provides a broad spectrum of viewpoints on the subject, particularly concerning its implementation by State Islamic Religious Councils (SIRCs) in Malaysia.

4. Discussion

4.1 Al-Mu'allafah Qulūbuhum and Its Application in Modern Time

Contemporary Islamic legal scholars have extensively debated the eligibility of non-Muslims to receive zakāt funds under the *al-Mu'allafah Qulūbuhum* category, resulting in diverse *fatāwa* on the matter. These pronouncements reflect a spectrum of scholarly interpretations seeking to address this issue within the context of contemporary societal realities in Malaysia and evolving jurisprudential considerations.

4.1.1 Zakāt Allocation to Al-Mu'allafah Qulūbuhum: A Contemporary Fiqh al-Wāqi' Perspective

The contemporary *fatwa* on the permissibility of allocating zakāt to non-Muslims finds substantiation in the scholarly opinion of the late Mufti of Saudi Arabia, [Sheikh 'Abdul 'Azīz ibn Bāz \(2007\)](#) as well as in a resolution issued by the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (OIC) during its 165th session (Resolution 18/3 of 2007). The discussion proceeds as follows:

4.1.1.1 The Opinion of the late Mufti of Saudi Arabia, Sheikh 'Abdul Azīz Ibn Bāz

The late Sheikh 'Abdul Azīz Ibn Bāz held the position that the allocation of zakāt funds to non-Muslims is permissible if the purpose is to reconcile their heart towards Islam, strengthen their faith, or provide support to help them remain steadfast in their beliefs. Additionally, zakāt disbursement may extend to non-Muslims for *da'wah* purposes to attract non-Muslims to Islam or potential conversion to Islam. However, in the absence of such reasons, support for non-Muslims should be provided through sources other than zakāt (['Abdul Azīz Ibn 'Abdullah Ibn Bāz, 2007](#)).

Suffice to say, zakāt funds are generally designated for Muslims. The zakāt disbursement to non-Muslims for *ta'lif al-qulūb* (reconciliation of hearts) is contingent upon the potential for positive religious outcomes, such as their conversion to Islam, influencing others towards Islam, or strengthening their positive disposition towards Muslims. Otherwise, if such religious benefits are not expected, non-Muslims should be supported from alternative sources other than zakāt, which is supporting the view of Al-Shirāzī (1995) from the Shāfi'ī school of thought, and Al-Zuhaylī (1985).⁷

4.1.1.2 International Islamic Fiqh Academy of the Organisation of Islamic Conference

The International Islamic Fiqh Academy, in Resolution 18/3 (2007), affirmed the continuing validity of the *al-Mu'allafah Qulūbuhum* category within zakāt disbursement. This allocation, the resolution clarifies, is not abrogated but rather contingent upon demonstrable *hājah* (need) and *maṣlahah* (benefit).⁸

This *fatwa* authorizes the strategic deployment of zakāt funds in specific exigencies. It permits zakāt expenditure to: (1) strengthen the *īmān* of new Muslims, offsetting disadvantages incurred post-conversion; (2) support non-Muslims, proactively for *da'wah* or defensively to avert communal harm; and (3) provide humanitarian relief to non-Muslim victims of natural disasters, aligning with the principle of *ta'lif al-qulūb*.

The International Islamic Fiqh Academy and Wahbah Al-Zuhaylī concur on the permissibility of humanitarian aid to non-Muslims during disasters but diverge on funding sources. The Academy emphasizes *ta'lif al-qulūb* (winning hearts) using zakāt funds, while Al-Zuhaylī (1985)⁹ advocates utilizing public funds beyond zakāt. Both view such aid as a preventative and a means of averting harm, although their justifications differ slightly.

4.1.2 Zakāt Allocation to Non-Muslims in the Malaysian Context

In 2025, the current population of Malaysia is 35,804,865,¹⁰ of that population, 63.5% are Muslim which is represented by the Shāfi'ī school of Sunni jurisprudence, and the remaining population is non-Muslims¹¹. In

وَأَجَازَ بَعْضُ الشَّافِعِيَّةِ إِعْطَاءَ الْكُفَّارِ مِنْ مَوَارِدِ بَيْتِ الْمَالِ الْعَامَّةِ، لِتَأْلِيفِ قُلُوبِهِمْ، وَهُوَ خُمْسُ الْخُمْسِ مِنَ الْفَيْءِ وَغَيْرِهِ، لِئِنَّهُ مَرْصَدٌ لِلْمَصَالِحِ
وَأَمَّا غَيْرُ الشَّافِعِيَّةِ الَّذِينَ أَجَازُوا دَفْعَ الزَّكَاةِ لِلْكَفَّارِ لِتَأْلِيفِ قُلُوبِهِمْ عِنْدَ الْحَاجَةِ، فَلَا يُطْبِقُونَ قَوْلَهُمْ عَلَى هَذَا الْعَامَّةِ، وَهَذَا مِنْهَا .

Some Shāfi'ī scholars have permitted giving non-Muslims from the public treasury resources to win their hearts, which is a fifth of the fifth from the spoils of war and other resources, as it is intended for public interests, and this falls under that. As for other scholars who permitted giving zakāt to non-Muslims to win their hearts when needed, this does not apply. As for those other than the Shāfi'īs who allowed giving zakāt to non-Muslims to win their hearts when needed, their statement does not apply to these situations. Rather, they intended for the act of winning hearts to lead, directly or indirectly, to conversion to Islam (Al-Zuhaylī, 1985).

⁸ International Islamic Fiqh Academy of Organization of Islamic Cooperation (OIC), *A Resolution on Enhancing the Role of Zakāh in Poverty Alleviation and the Management of Its Collection and Distribution Based on Fiqh Interpretations (Ijtihād)*, Resolution No. 165 (18/3). It stated that:

“The allocation of zakāt to “those whose hearts are to be reconciled” remains valid as long as life continues; it has neither been abolished nor abrogated. Its application depends on *hājah* (need) and benefit. Whenever a need or benefit arises, this allocation will trigger.”

“It is permissible to give zakāt to strengthen the faith of new Muslims as a form of assistance for any losses they may have incurred. Similarly, zakāt may be given to a non-Muslim if there is hope they may embrace Islam or to prevent harm from them against Muslims.”

“It is also permissible to provide support from zakāt funds to non-Muslims affected by disasters, earthquakes, floods, and famines, in order to win over their hearts.

لَكِنْ لَمَّا نَعِ شُرْعًا مِنْ دَفْعِ شَيْءٍ مِنْ أَمْوَالِ الْمُسْلِمِينَ الْعَامَّةِ مِنْ غَيْرِ الزَّكَاةِ لِغَيْرِهِمْ لِنَفْعِ شَيْءٍ مِنْهُمْ وَرَفْعِ صَرْبِهِمْ وَرَجَاءِ خَيْرِهِمْ، كَمَا صَرَّحَ الْفُقَهَاءُ، فَيَجُوزُ أَنْ نُدْفَعَ شَيْئًا مِنْ أَمْوَالِنَا بِصِفَةِ تَبَرُّعًا فِي أَوْقَاتِ الْمَحْنِ وَالزَّمَانِ، وَالْكَوَارِثِ وَالنَّكَابَاتِ كَالزَّلْزَلِ وَالْفَيْضَانَاتِ، فِي ذَلِكَ نَوْعٍ مِنَ الْوَقَايَةِ وَسَدِّ الدَّرَائِعِ.

However, there is no religious objection to giving some of the public funds of Muslims, aside from zakāt, to others to prevent their harm, alleviate their suffering, and hope for their good, as the jurists have stated. It is permissible to donate some of our money as charity during times of hardship, crises, disasters, and calamities such as earthquakes and floods, as this serves as a form of prevention and a means to close off harmful avenues (Al-Zuhaylī, 1985)

¹⁰ As of Sunday, February 2, 2025, based on Worldometer's elaboration of the latest United Nations data. *Malaysia Population (LIVE)* <https://www.worldometers.info/world-population/malaysia-population/>

¹¹ Religious demographics in Malaysia, excluding Muslims, are as follows: Buddhists constitute 9.1% of the population, Christians 6.1%, Hindus 1.8%, atheists 1.8%, and adherents of other faiths, including animism, Confucianism, Taoism, Sikhism, and Baha'i, comprise 0.9%. U.S Department of State, *Malaysia 2023 International Religious Freedom Report*, Section I. Religious Demography, p.4. Please refer to <https://www.state.gov/>

light of this diverse demographic, the dispensation of zakāt necessitates tailored strategies for non-Muslims, where religiously permissible. Assuming the continued relevance and validity of this zakāt category in modern socio-economic contexts, what are the ethically and legally sound *raison d'être* for its disbursement? Furthermore, how can these allocations be strategically deployed to effectively operationalize the objectives of *ta'līf al-qulūb* (reconciliation of hearts) within the contemporary *wāqi'*, specifically with regard to attracting individuals to Islam, strengthening the faith of existing Muslims, bolstering the resolve of those with weaker faith, garnering support for *da'wah*, and preempting harm to Muslims?

Within the Malaysian Islamic legal framework, the administration of zakāt exhibits a tripartite division of powers.¹² Therefore, Malaysia maintains a well-structured system for the collection and distribution of zakāt funds. The administration of zakāt is under the purview of the Sultan in each state, while the Federal Government oversees zakāt affairs in the federal territories (Diana, et. al., 2020). The interpretation and application of the term *al-Mu'allafah Qulūbuhum* varies among Malaysian state-level Islamic authorities i.e. State Islamic of Religious Councils (SIRC), leading to diverse approaches in its implementation.

JAWHAR (2007) in Zakat Distribution Management Manual defines the *al-Mu'allafah Qulūbuhum* category of recipients as encompassing individuals who are recent converts to Islam; influential Muslim leaders fostering interfaith harmony; influential leaders of newly established Muslim communities; Muslims in border regions vulnerable to external threats; and non-Muslims whose conversion is plausible or whose animosity towards Muslims could be mitigated through zakāt.¹³

The non-Muslims inclusion rests on the strategic objective of either encouraging conversion (plausible converts) or mitigating potential harm (those with animosity), thus aligning with the broader Shari'ah objective of promoting the welfare of the Muslim community (*maṣlahah*) and potentially expanding its reach through peaceful means. This interpretation suggests zakāt can be utilized for strategic outreach, provided it serves a demonstrable Maqāṣid al-Shari'ah. JAWHAR manual aligns with the established rulings of the 79th Fatwa Committee of the National Council of Islamic Religious Affairs, Malaysia¹⁴ that was tabled between 6th and 8th September 2007. Zakāt distribution prioritizes eligible Muslim recipients, but Islamic political exigency (*siyāsah*) permits governmental allocation of zakāt funds to non-Muslims for *da'wah* purposes.

The concept resonates with the views of Yūsuf Al-Qaradāwī (1973), who articulates two primary positions on the permissibility of zakāt distribution to non-Muslims. The first encompasses *al-Mu'allafah Qulūbuhum*, a category explicitly mentioned in the Qur'ān as eligible recipients of zakāt. This group may include recent converts to Islam or those non-Muslims demonstrating an inclination towards or affinity with the faith. The second perspective extends eligibility to indigent non-Muslims, specifically those experiencing financial hardship and in need of assistance, aligning with the broader objectives of zakāt in addressing poverty and social needs (Diana et. al., 2020). The primary purpose of zakāt is to alleviate poverty and improve the economic well-being of the Muslim community (Rahmatya & Wicaksono, 2018; Ali, et. al., 2019).

Needless to say, zakāt, while fundamentally aimed at the socio-economic upliftment of the Muslim *ummah*¹⁵, permits disbursement to non-Muslims under specific, contextually defined parameters. JAWHAR permits the allocation of zakāt funds to non-Muslims when deemed beneficial for promoting peaceful relations

¹² SIRC holds supreme authority over zakāt administration, setting policies and overseeing operations. The Jabatan Mufti is the sole issuer of zakāt-related fatwas, while the Mahkamah Syariah adjudicates legal matters concerning zakāt. This structure establishes the SIRC as the central governing body for all religious affairs pertaining to zakāt.

¹³ Kriteria Asnaf Muallaf. Asnaf Muallaf hendaklah bercirikan sekurang-kurangnya satu daripada perkara berikut:

- i. Baru memeluk agama Islam.
- ii. Ketua-ketua masyarakat Islam yang baik hubungan dengan ketua-ketua kumpulan bukan Islam yang sejawatan atau sama taraf dengannya.
- iii. Ketua-ketua masyarakat Islam yang masih lemah iman tetapi masih ditaati oleh orang-orang di bawah pimpinannya.
- iv. Orang-orang Islam yang tinggal di perbatasan yang berhampiran dengan negara musuh Islam.
- v. Orang bukan Islam yang boleh dipujuk supaya menganut Islam.
- vi. Orang bukan Islam yang boleh dipujuk supaya tidak mengancam orang-orang Islam.

¹⁴ 'Priority of zakāt distribution should be given to the Muslim community according to the group of people identified in the Qur'ān as eligible to receive the zakāt; however, the government is allowed to distribute the zakāt income to non-Muslims based on Islamic politic/siyāsah and needs for the purpose of Islamic da'wah'

¹⁵ For instance, historical record shows that Sultan Muhammad al-Fatih, while prioritizing Muslim manpower in his army, did not hesitate to utilize the expertise of non-Muslim artisans and craftsmen in various fields, including weaponry, funded through diverse revenue streams, and zakāt.

with the Muslim community or encouraging potential conversion to Islam. This practice, while acknowledged within Islamic jurisprudence, is often subject to scholarly discourse and necessitates careful consideration of established guidelines and objectives.

4.1.3 A Critical Evaluation of the SIRC Approach to Non-Muslims Categorized as *Al-Mu'allafah Qulūbuhum* in Malaysia

While zakāt disbursement prioritizes Muslim *aṣṅāf*, the SIRC may exercise discretion to allocate zakāt funds to non-Muslims in certain circumstances, through mechanisms such as property ownership (*tamlīk al-a'yān*) or beneficial ownership (*tamlīk al-manfa'ah*),¹⁶ with the intention of promoting Islamic proselytism (*da'wah*)¹⁷. These forms of ownership can be acquired directly (*tamlīk mubāshir*) or indirectly (*tamlīk ghayr mubāshir*)¹⁸, enabling zakāt distribution to a broader spectrum of recipients, for instance, the provision of dialysis machines and hospital beds; *da'wah* efforts with clean water and sanitation facilities; along with educational programs, shows the power of active and responsive community engagement, which also benefiting non-Muslims. However, specific conditions and parameters must be met to justify the approach.

The contemporary *fatwa* on the permissibility of allocating zakāt to non-Muslims categorized as *al-Mu'allafah Qulūbuhum* finds support in the scholarly opinion of Sheikh 'Abdul 'Azīz ibn Bāz and the resolution issued by the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (OIC) in its 165th session (18/3) of 2007. According to Fatwa Collection System of Selangor State Zakat 2012,¹⁹ there are four categories of *mu'allaf* i.e. non-Muslims who have recently embraced Islam; non-Muslims who are hoped to embrace Islam; those with the potential to influence others to embrace Islam; and non-Muslims who perceived as a threat to Muslims.



Graph 1: Zakāt Funds Distribution Among *Mu'allaf* in Malaysia

Source: Adapted from Fatwa Collection System of Selangor State Zakat 2012, with some modifications from Authors.

¹⁶ *Tamlīk al-manfa'ah*, as implemented by Zakāt Selangor, facilitates the extension of zakāt benefits to non-Muslim recipients, where segregation is difficult, or where it is feared to cause *fitnah* (discord). This is supported by a 2018 fatwa from Kedah, which permits the provision of dialysis machines, potentially utilized by non-Muslims, under the categories of *aṣṅāf al-mu'allafah qulūbuhum*, *al-ghārimīn*, and *fī sabīlillah*. This approach allows for a broader distribution of zakāt *tamlīk al-manfa'ah*, encompassing non-Muslims in need. The *fatwa* stipulates that, "in this regard, based on the Zakat Institution, the medicalequipmentprovidedshould also usetheallocation of *aṣṅāf al-mu'allafah qulūbuhum*, *al-ghārimīn*, and *fī sabīlillah*. so that the benefits can be shared with patients among non-Muslims". Distributing zakāt funds through in-kind provisions (*Tamlīk al-manfa'ah*), demonstrates a permissible avenue for aiding non-Muslims, includes food distribution at Rumah Panjang in Sarawak, provision of hospital beds in Selangor accessible to all patients regardless of faith, and monthly allowances to indigenous community and Tok Batin in Kedah, where a minority of recipients are non-Muslim. A water pump project by Etiqa, funded through *wakālah*, further exemplifies this principle by benefiting both Muslim and non-Muslim communities.

¹⁷ For instance, PERKIM utilises zakāt for *da'wah* activities; and in 2022, Maybank Islamic's WASH programme benefitted 7232 homes and raised over RM2.5M through the zakāt fund. Maybank, "Water for Life", 18 May 2023, <https://www.maybank.com/en/blogs/2023/05/18.page>

¹⁸ Zakāt initiatives, exemplified by Bangladeshi factories' *tamlīk al-manfa'ah*, demonstrate inclusive approaches i.e. where shares are for Muslims, but benefits extend to both Muslim and non-Muslim beneficiaries.

¹⁹ Pursuant to section 47 of the Administration of the Religion of Islam (State of Selangor) Enactment 2003 [En. 1/2003], the Fatwa Committee for the State of Selangor, on the direction of His Royal Highness the Sultan prepare the Fatwa as set out in the Schedule and is published pursuant to subsection 48(6) of the Enactment. Refer to <https://www.zakat Selangor.com.my>

The categorization of non-Muslim recipients of zakat varies among Malaysian Islamic authorities. While Lembaga Zakat Selangor (PZS), Pusat Zakat Melaka (PZM), and Majlis Agama Islam Sarawak (MAIS) classify them as recent converts, Pusat Kutipan Zakat Pahang (PKZP) and Majlis Agama Islam Wilayah Persekutuan (MAIWP) maintain their non-Muslim status. Furthermore, MAIWP and Majlis Agama Islam dan Adat Melayu Terengganu (MAIDAM) further categorize non-Muslims into two types: those who can potentially be convinced to embrace Islam and those who can be persuaded not to oppose the Muslim community and government (Ab. Rahim, 2010).

Although zakāt disbursement to non-Muslims may raise concerns regarding potential *fitnah*, this must be evaluated through the lens of established jurisprudential principles²⁰, prioritizing greater *maṣlahah* over lesser *mafsadah*. However, the ethical and jurisprudential implications of employing zakāt funds for purposes that may indirectly benefit non-Muslims warrant careful consideration within the broader discourse on the permissible scope of zakāt disbursement.

The State Enactments regarding the administration of Religious Affairs also allocate zakāt funds to those who have converted to Islam. Additionally, the Enactment on the administration of Islamic Religious Affairs in Terengganu recognizes those who have converted to Islam, as they have conveyed and pronounced the testimony with conviction, known as the *Shahādah*²¹.

Despite such a statement, the zakāt funds intended for those who have converted to Islam are clearly allocated to them, and the government has yet to exercise the right to distribute the funds to non-Muslim communities with the intention of promoting Islamic proselytism (*da'wah*), or those facing financial hardship, because the primary purpose of zakāt is to support the welfare of the Muslim community. The distribution of zakāt funds to non-Muslims must be carefully considered and balanced against this primary objective, taking into account the prevailing social, political, and economic conditions in Malaysia.

The Majlis Agama Islam dan Adat Istiadat Melayu Kelantan (MAIK) suggest that the term *al-muallafah qulūbuhum*, according to Madhab Shāfi'ī, only refers to Muslims. In addition, MAIK's fatwa committee also explained that the meaning of *da'wah* is the distribution of zakāt funds to the indigenous people. Part of the *fatwa* is shown below:

"In the context of *da'wah*, especially *da'wah* to the aborigines in the state of Kelantan, the meeting of the fatwa council decided that the distribution of zakāt also concerns non-Muslims. The decree is specifically for the purpose of *da'wah*, mainly for the benefit of *Siyāsah al-Shar'iyah* to spread the Islamic religion".

The Perlis Mufti²² in the State Fatwa Committee held its 26/2017 meeting on 3rd February 2017, articulated a broad interpretation of zakāt distribution to *al-Mu'allafah Qulūbuhum* suggesting its permissibility for non-Muslims. This interpretation maintains its relevance and could serve *da'wah* purposes, mitigating potential harm to the Muslim community, and ultimately fostering receptiveness towards Islam.

The SIRC authorities in Selangor, Melaka, Negeri Sembilan, Sabah, Penang, Perlis, Kelantan, Terengganu, and Sarawak²³ have adopted a consensus in defining non-Muslims who have recently embraced Islam as those who have unequivocally professed the *Shahādah*, following the discussion of Al-Zuhaylī (1985). This classification aligns with classical Islamic jurisprudence, which stipulates that the declaration of faith constitutes a prerequisite for eligibility in the allocation process.

In contrast, the Majlis Agama Negeri Pulau Pinang (MAIPP), during the Muzakarah Penetapan Pengesahan Hukum dan Dasar Agihan MAIPP on the 26th to 28th September 1998, clearly stated that zakāt funds should not be distributed to non-Muslims. The statement was based on the opinion of Madhab Shāfi'ī in *Kitāb Fiqh al-Islāmī Waadilah*, as discussed by al-Zuhaylī (1985), "Zakāt cannot be given to the heathen group regardless of whether its aim is to invite them to convert to Islam or to achieve any other purpose. During the

²⁰ This possibility should be considered within the framework of the legal maxim when both the *maṣāliḥ* and the *mafsād* are involved, e.g. *أَجَلُ الْمَصْلَحَةِ الْكَبِيرَةِ مِنْ أَجْلِ الْمَصْلَحَةِ الْكَبِيرَةِ*. 'A small *mafsadah* is excused to bring a great *maṣlahah*,' *أَدَائِمَةُ الدَّائِمَةِ* *أَجَلُ الْمَصْلَحَةِ الْكَبِيرَةِ مِنْ أَجْلِ الْمَصْلَحَةِ الْكَبِيرَةِ*. 'A temporary *mafsadah* is allowed for a lasting *maṣlahah*'.

²¹ Enactment 2, Year 2001, Section 92 states that: "A person is considered a Muslim once the person (utters the *Shahādah*) pledge that Allah is the only God and Muhammad is Allah's messenger, and the requirement of section 91 is fulfilled; and that person is known as *mu'allaf*".

²² The Perlis mufti, Datuk Mohd Asri Zainul Abidin mentioned that: "Muallafs are not just those who have newly embraced Islam as interpreted by certain parties. In fact, they include persons who have not embraced Islam and is hoped they would convert to Islam through this zakat distribution. Even to the non-Muslims, it is hoped by giving this zakat they won't hurt Muslims and love Islam".

²³ Pursuant to section 47 of the Administration of the Religion of Islam (State of Selangor) Enactment 2003.

beginning of Islam, the heathen group was given zakāt due to the small number of Muslims, while many were non-Muslims. Since Islam, Muslims have been honoured by the grace of Allah (SWT) and also the heavy numbers of Muslims, the zakāt allocation for ‘those whose hearts are inclined (towards Islam)’ group was no longer relevant. The Rāshidūn Caliphate also did not give them charity. Even Caliph ‘Umar al-Khaṭāb said, ‘We will not give something for them to Islam. They can choose either to believe in Islam or in the other way around’.

Nevertheless, within the context of *da’wah*, the disbursement of zakāt extends to non-Muslim populations. This allocation is specifically designated for *da’wah* purposes, primarily to advance *Siyāsah al-Shar’iyyah* and propagate the Islamic faith, particularly among indigenous communities.

6. Conclusion and Recommendation

In Malaysia, the allocation of zakāt funds to non-Muslims designated as *al-Mu’allaḥah Qulūbuhum* is permissible for *maṣlaḥah* (public interest) purposes, such as fostering positive interfaith relations and potentially encouraging *da’wah*. This is concurred by Sharī’ah experts and few SIRC’s who opine that such allocation is permissible within specific parameters and considerations, aligning with broader Sharī’ah objectives. The primary *raison d’être* of zakāt remains the socio-economic upliftment and amelioration of the Muslim *ummah*. Although zakāt primarily serves Muslim *aṣnāf*, SIRC’s may, under specific circumstances, allocate funds to non-Muslims *al-muallaḥah qulūbuhum*, where segregation is difficult, or where it is feared to cause *fitnah* (discord). This can be facilitated through *tamlīk al-a’yān* (outright ownership) or *tamlīk al-manfa’ah* (beneficial ownership), whether *mubāshir* (direct) or *ghayr mubāshir* (indirect), for *da’wah* objectives, thus expanding the beneficial reach of zakāt. Therefore, a comprehensive review of existing *fatwa* by SIRC’s is warranted to reconcile these perspectives and ensure alignment with established Sharī’ah principles and contemporary needs.

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Promoting Investment in Takaful Insurance through Optimized Capital Inflow Strategies

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Abstract

This study examines capital inflow strategies in Takaful insurance, focusing on their role in sustaining solvency, managing participants' fund deficits through *qard hasan*, and supporting long-term growth, thereby balancing Takaful's ethical mission of mutual assistance with the commercial need to attract sustainable shareholder investment. This study adopts a qualitative and exploratory approach, drawing on secondary data from regulatory frameworks, company reports, and international case studies. Thematic content analysis was applied to assess the role of capital across the Wakalah, Mudarabah, Hybrid, and Waqf models, while comparative case analysis highlighted international best practices. The findings reveal that governance quality, Shariah compliance, transparency, and robust solvency frameworks are critical for building investor confidence, although challenges persist in the form of high compliance costs, limited Shariah-compliant investment instruments, and competitive pressure from conventional insurers. International experiences, particularly in Malaysia, Saudi Arabia, and the UAE, demonstrate that supportive legislative environments, financial innovation, and fintech integration can successfully mobilize capital inflows into Takaful. The originality of this study lies in synthesizing capital strategies across multiple Takaful models and linking them with international experience to generate practical insights. It concludes that harmonized regulation, transparent governance, and technological innovation are essential for strengthening Takaful's resilience and positioning it as a competitive, ethical, and sustainable alternative in the global financial system.

Keywords: Takaful, Capital inflows, Shariah compliance, Investment strategies

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1.0 Introduction

The global Islamic finance industry, encompassing the Takaful insurance sector, has undergone substantial expansion over the past few decades, presenting significant opportunities and complex challenges. Takaful, conceived as a Shariah-compliant alternative to conventional insurance, is founded on the principles of mutual assistance, shared responsibility, and collective risk-bearing, whereby participants contribute a common fund designed to provide financial support in times of need. Within this framework, capital plays a pivotal role in safeguarding both the sustainability and long-term growth of the sector (Warkab & Munir, 2022). Moreover, the continued development of Takaful depends on robust capital structures and the implementation of innovative strategies that effectively attract and optimize investment inflows. Therefore, a nuanced understanding of capital mobilization dynamics is indispensable for policymakers, investors, and Takaful operators, as it strengthens industry resilience while enhancing competitiveness within the broader Islamic finance landscape.

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A central challenge for the Takaful industry lies in reconciling its social mission, rooted in mutual cooperation and equitable risk-sharing, with the commercial imperative of attracting and retaining shareholder capital. Although Takaful is frequently structured on a non-profit basis, with surpluses redistributed to participants (Mohammed & Bouhlit, 2018), operators rely on shareholder investments to establish and expand their businesses, meet regulatory requirements, and sustain market competitiveness. Shareholders, in turn, typically expect financial returns on their contributions, creating structural tension between the social objectives of participants and the commercial expectations of investors (Warkab & Munir, 2022). Effectively balancing these competing imperatives is therefore essential to preserving the distinct identity of Takaful and ensuring its long-term viability.

Despite the sector's overall expansion (IFAC, 2022), attracting sufficient and sustainable capital remains a pressing concern. This challenge is driven by the distinctive operational models of Takaful, the complexity of regulatory frameworks, and the need to reconcile equitable participant benefits with competitive shareholder returns. Within this context, it is critical to examine the role of capital across different Takaful models and the nature of the returns generated. It is also necessary to explore how capital can be strategically deployed to address deficits in participants' funds and evaluate profit distribution mechanisms that ensure fairness between shareholders and policyholders. Furthermore, regulatory and compliance challenges that restrict capital inflows require careful attention, along with the consideration of how legislative frameworks can enhance the sector's attractiveness. Finally, lessons from international experience, as well as the potential of financial innovation and fintech, warrant close examination to strengthen the efficiency of capital utilization within Takaful.

In response to these issues, this study sets several key objectives. It aims to analyze the role of capital and the returns it generates across different Takaful models, evaluate mechanisms for managing deficits in participants' funds, and examine profit distribution frameworks that balance the interests of shareholders and policyholders. Additionally, this study seeks to identify the principal challenges associated with capital in Takaful, propose viable solutions, explore how legislative and regulatory environments can enhance investment attractiveness, and assess the extent to which financial innovation and fintech can optimize capital mobilization and utilization strategies.

By focusing on the promotion of investment in Takaful Insurance through optimized capital inflow strategies, this study contributes to the broader literature on Islamic finance by providing a comprehensive analysis of capital dynamics and their implications for the sector's long-term sustainability. The findings are expected to generate practical insights for policymakers designing supportive regulatory frameworks for investors evaluating opportunities within the Takaful market and for operators seeking to balance commercial viability with the sector's social mission.

2.0 Literature Review

2.1 Takaful Insurance Models: An Overview

The various Takaful insurance models provide a foundation for understanding the functioning of capital within this sector. These models differ in the structuring of the relationships between participants and operators, which in turn affects the treatment of shareholder capital and the generation of returns. Therefore, a clear understanding of these models is essential for analyzing the sector's capacity to attract investment.

The Wakalah model, which is widely adopted in the Takaful industry, operates on an agency principle. In this model, the Takaful operator acts as an agent (*wakil*) for the participants, managing their funds in exchange for agency fees. This fee is typically calculated as a percentage of contributions or is based on performance metrics (Puspita et al., 2020). The Wakalah model maintains a clear separation between shareholder capital and participant funds, with shareholders generating returns from their investments. In some instances, operators may also receive a portion of the surplus from participants' funds, providing an additional revenue stream (Yusoff, 2018).

The Mudarabah model, based on the principle of profit sharing, positions the Takaful operator as an entrepreneur (*mudarib*) responsible for managing participants' funds. The profits generated under this arrangement are shared between participants and shareholders according to a pre-agreed ratio (Saeed, 2019). This model also allows for the provision of *qard hasan*, an interest-free loan from shareholder capital to participants' funds in case of a deficit (Puspita et al., 2020). However, the Mudarabah model has faced challenges owing to its high-risk nature, leading to its discontinuation in some markets such as Malaysia, where it was replaced by the Wakalah model. For instance, the Mudharabah contract can present operational

complexities for Takaful operators because their profitability is contingent on factors such as increasing premium rates, optimizing returns on invested assets, and expanding policy sales, all of which are challenging to achieve in competitive markets (Sallemi & Zouari, 2023).

The Hybrid model combines elements of both the Wakalah and Mudarabah frameworks, aiming to balance the stability and growth potential in Takaful operations. This model allows operators to earn a Wakalah fee for fund management while also participating in investment profits through a Mudarabah arrangement (Puspitasari, 2015). The Hybrid model offers several advantages, including diversified revenue streams for operators, enhanced fairness through the separation of operational costs and investment outcomes, and improved incentives to maximize fund performance. For investors, this model presents a more balanced risk profile and the potential for higher returns.

The Waqf model, a relatively recent innovation in Takaful practice, has gained prominence in certain markets, particularly in Pakistan (Susiatin & Haji-Othman, 2023). This model establishes the Takaful fund as a cash waqf or endowment created by shareholders who act as the founders of the fund. Once established, the Waqf Fund becomes a perpetual trust dedicated to serving the collective interests of participants. In this model, shareholder returns are primarily generated by investing their own capital in Shariah-compliant instruments rather than deriving income directly from participants' contributions or profit-sharing arrangements (Susiatin & Haji-Othman, 2023). The Waqf model emphasizes social solidarity, governance, and participant protection. It maintains a clear separation between participant funds and shareholder profits, with the Waqf Fund being designed to be self-sustaining through participant contributions. In the event of deficits, the fund may receive a qard hasan (interest-free loan) from shareholders, further reinforcing the model's focus on mutual support and risk sharing (Sulaiman et al., 2019).

Each Takaful model has unique characteristics that influence its risk profile, potential returns, and overall attractiveness to investors. The Wakalah model offers stability through fixed agency fees but may limit the upside potential for operators. The Mudarabah model, although potentially more lucrative, carries higher risks and faces regulatory challenges. The Hybrid model attempts to strike a balance between these approaches by offering a more flexible structure that can adapt to different market conditions and regulatory requirements. The Waqf model, with its emphasis on social responsibility and clear separation of funds, presents a distinct approach that may be particularly appealing in markets where religious and cultural considerations play a significant role in financial decision making. Hence, the choice of the Takaful model significantly affects the sector's ability to attract investment and sustain growth. Factors such as the regulatory environment, market maturity, and cultural preferences play a role in determining the most suitable model for a given context. As the Takaful industry continues to evolve, understanding these models and their implications becomes increasingly important for operators, regulators, and potential investors.

In conclusion, the diversity of Takaful's insurance models reflects the sector's ongoing efforts to balance Shariah compliance, operational efficiency, and attractiveness to investors. Each model presents unique advantages and challenges, highlighting the need for careful consideration in model selection and implementation to ensure long-term sustainability and growth of the Takaful industry.

2.2 The Nature and Role of Capital in Takaful Companies

The nature and role of capital in Takaful companies extend beyond mere financial support, encompassing multiple critical functions that align with the Shariah principles and regulatory requirements. This literature review explores the multifaceted role of capital in Takaful's operations, its impact on financial health, and the mechanisms through which it generates returns for shareholders.

2.2.1 The Role of Capital in Takaful Operations and Financial Health

Capital in Takaful companies serves several key purposes. Primarily, they provide the foundational resources necessary for establishing and initiating operations (Archer et al., 2011). Additionally, it ensures compliance with minimum regulatory requirements, safeguards the company's financial stability, and protects policyholders (IFSB, 2010). A unique aspect of Takaful capital is its role in deficit management through the provision of interest-free loans (qard hasan) to participants' funds during periods of deficit. This mechanism distinguishes Takaful from conventional insurance models, reflecting its Shariah compliant risk-sharing framework (Billah, 2019).

Furthermore, capital facilitates product innovation, market expansion, technological advancement, and overall business growth (Obaidullah, 2015). A robust capital base also signals financial strength and stability to investors, regulators, and participants, thereby enhancing market credibility and confidence (Ahmed, 2016). The role of capital in Takaful operations is closely linked to these companies' profitability and long-term sustainability. The manner in which capital generates returns within the Shariah-compliant framework of each operational model significantly affects the appeal to potential investors (Khan & Najeeb, 2017).

Different Takaful models employ distinct mechanisms for capital utilization and return generation. In the Agency (Wakalah) model, shareholders' capital primarily generates returns through investments in Shariah-compliant assets and via wakalah (agency) fees charged to the participants' funds. These fees, typically structured as a percentage of contributions, provide operators with a relatively stable and predictable revenue stream (Yaacob, 2012). On the other hand, the Mudarabah Model positions shareholders as mudarib (entrepreneurs), sharing profits derived from the investment of participants' funds according to a pre-agreed profit-sharing ratio (Saeed, 2019). While this model offers the potential for higher returns, it also introduces greater variability than the fixed income derived from agency fees. The Hybrid Model integrates the features of both wakalah and mudarabah, enabling operators to benefit from both agency fees and profit-sharing. This combination provides a more diversified and balanced revenue profile, mitigating some of the volatility associated with pure Mudarabah arrangements (Sallemi & Zouari, 2023). In select markets, notably Pakistan, the Waqf Model is used, where returns are primarily generated from the investment of shareholders' own capital. The waqf fund is designed to be self-sustaining, although it may occasionally be supplemented by qard hasan from shareholders when required (Sulaiman et al., 2019).

2.2.2 The Role of Capital in Addressing Deficits in the Participants' Fund

A critical role of capital in Takaful companies is to address deficits in participants' funds. Despite Takaful's risk-sharing principle, instances may arise where claims exceed contributions and investment returns, resulting in a deficit. In such circumstances, shareholders' capital plays a vital role in maintaining solvency and protecting participants through the provision of qard hasan (Abdul Rahman, 2019; Archer et al., 2011). This mechanism ensures financial continuity, preserves fund solvency, and safeguards policyholder interests. These interest-free loans are repaid from future surpluses of participants' funds, emphasizing their temporary nature and role as a Shariah-compliant safety net (Billah, 2019).

However, the provision of qard hasan does not have implications for shareholders. While interest-free, these loans temporarily restrict the liquidity of shareholders' capital and impose opportunity costs until repayment (Khan & Najeeb, 2017). Persistent or substantial deficits may adversely affect investor confidence and diminish the attractiveness of additional capital contributions (IFSB, 2010). This approach highlights how Takaful operators balance Shariah-compliant risk-sharing with financial stability, leveraging shareholder capital to mitigate fund deficits while maintaining the confidence of both participants and investors (Yaacob, 2012). Attracting investment in Takaful companies requires demonstrating both competitive and sustainable returns on capital (Ahmed, 2016).

2.2.3 Returns on Capital in Takaful Companies

Shareholders' returns are realized through several key channels, reflecting the structure of the operational model and Shariah-compliant investment framework. Agency fees under the Wakalah model provide a predictable and stable source of revenue for operators, forming a primary component of shareholder income. In mudarabah arrangements, shareholders participate in profits through a predetermined share of the investment surplus generated from participants' funds, linking returns directly to fund performance. Investment income is another significant source of shareholder return. Capital is invested in Shariah-compliant assets, generating direct financial returns and contributing to capital growth, thereby enhancing a company's overall financial resilience. The performance of Takaful companies is commonly assessed using metrics such as the Return on Equity (ROE) and Return on Assets (ROA). Recent industry examples demonstrate the potential of attractive returns in the Takaful sector. For instance, Al Rajhi Takaful reported a return on capital (ROC) of 15.9% by 2024. Bupa Arabia recommended a 40% cash dividend distribution for the 2024 fiscal year. Similarly, Al-Tawuniya (The Company for Cooperative Insurance) achieved a net profit of SAR 1.02 billion in 2024, a 65.8% increase over the previous year.

In conclusion, the nature and role of capital in Takaful companies are multifaceted and integral to their operations, financial health, and investor attractiveness. Capital serves not only as a financial resource, but also as a mechanism to ensure Shariah-compliant risk-sharing, operational resilience, and long-term investor confidence. The various Takaful models demonstrate different approaches to leveraging capital to generate returns, while adhering to Islamic principles. The unique feature of qard hasan highlights the dual role of capital as both a commercial investment and Shariah-compliant safety net. As the Takaful industry continues to evolve, understanding and optimizing the role of capital will remain crucial for ensuring the sector's growth, stability, and appeal to both participants and investors.

2.3 Profit Distribution Mechanisms in Joint Investments between Shareholders and Policyholders

Fair and transparent profit and surplus distribution constitute a cornerstone of Takaful's operational integrity. This practice not only fosters trust among participants but also enhances the attractiveness of Takaful institutions to investors by signaling operational stability and compliance with Shariah principles (Bouchada & Ouzazna, 2022; IFSB, 2013). Within this framework, the participants' surplus represents the residual funds available in the pool after the settlement of claims, deduction of operational expenses, and repayment of any qard hasan (interest-free loan) advanced by shareholders to cover deficits. The surplus may be distributed among participants in proportion to their contributions, thereby providing a tangible financial return for their participation in the risk-sharing scheme. Alternatively, it may be retained within the fund to strengthen reserves, a measure that enhances the pool's financial resilience and ensures sustainability. In either case, the mechanism reinforces the principle that participants directly benefit from prudent fund management and investment performance while safeguarding the long-term stability of the operation (Bouchada & Ouzazna, 2022; Khan & Hassan, 2017).

Shareholders, on the other hand, generate profits through a combination of fee-based and performance-based revenue streams. Under the wakalah model, they earn agency fees as predetermined compensation for administering participants' funds, while the mudarabah model allows them to share in the profits generated by investing participants' contributions according to an agreed ratio. In addition, shareholders may invest their own capital in Shariah-compliant assets, yielding independent returns and diversifying their income sources. This mix of predictable fees and performance-driven profits aligns shareholder incentives with fund efficiency and participant satisfaction, while maintaining a balance between stable and variable income streams (Ayub, 2019; Bouchada & Ouzazna, 2022).

Crucially, transparency and Shariah compliance remain central to the credibility of these arrangements. Profit and surplus distribution mechanisms must be explicitly defined, communicated, and documented to prevent disputes and promote equitable treatment. By avoiding prohibited elements such as gharar (excessive uncertainty) and riba (interest), and through oversight by Shariah Supervisory Boards in line with governance standards prescribed by AAOIFI and IFSB, Takaful institutions reinforce ethical accountability and operational legitimacy. Such transparency and compliance not only sustain long-term participant engagement but also enhance investor confidence in the sector (AAOIFI, 2021; IFSB, 2013; Khan & Hassan, 2017).

2.4 Shareholders' and Participants' Rights in Companies and Boards of Directors across Takaful Models

The governance structures of Takaful companies are distinctive because they reflect the dual interests of shareholders and participants. Unlike conventional insurers, where shareholder primacy dominates, Takaful is designed to balance commercial objectives with the collective rights of participants, in line with its risk-sharing ethos and Shariah requirements (Warkab & Munir, 2022). Shareholders in Takaful companies generally hold rights comparable to those in conventional corporations, including voting rights in general meetings, entitlement to dividends derived from company profits, and representation on the board of directors where strategic and operational decisions are made. These rights provide shareholders with the authority to influence the direction of the company and protect their financial interests, ensuring accountability in corporate management (Al Tawuniya, 2023).

Participants, by contrast, hold a unique position as collective owners of the Takaful fund, which differentiates Takaful governance from conventional insurance models. Their primary entitlement lies in the distribution of any surplus generated by participants' funds after claims, expenses, and any outstanding qard hasan have been settled. In some jurisdictions, participants are further empowered by having representation within Shariah supervisory boards or advisory committees, giving them a direct voice in governance. Such

rights ensure that participants are not merely passive policyholders but active stakeholders in a cooperative system that emphasizes shared responsibility and mutual benefit (Bounchada & Ouzazna, 2022).

A defining feature of this governance framework is the Shariah Supervisory Board, an independent body tasked with ensuring that all operations, including capital management and profit distribution, comply with Islamic principles. The board provides guidance on Shariah-compliant practices, monitors adherence, and resolves issues of jurisprudence that may arise in the course of operations. By fulfilling this oversight function, the Shariah Supervisory Board not only enhances internal governance but also strengthens market credibility and investor confidence in the ethical integrity of Takaful institutions (Bouafoula, 2021; Bank Negara Malaysia, 2018). Overall, the governance of Takaful companies is characterized by dual accountability, where shareholders provide capital and participants collectively own the fund. This distinctive structure reinforces the cooperative and ethical foundations of Takaful while simultaneously ensuring financial sustainability, regulatory compliance, and adherence to Shariah principles.

2.5 The Role of Capital in Solvency and the Rating of Takaful Companies

Capital represents the cornerstone of solvency in Takaful companies and serves as a critical indicator of financial health and the ability to meet future obligations. It provides assurance not only to regulators and rating agencies, but also to participants and investors who rely on the strength of the operator to ensure the continuity of risk-sharing arrangements (Minimum Requirements, 2019). Regulatory authorities have established minimum capital thresholds to ensure that Takaful companies are capable of absorbing unexpected losses and sustaining financial stability. Compliance with these requirements is vital for protecting participants' interests and for maintaining systemic stability within the broader Islamic financial sector (Minimum Requirements, 2019).

Moreover, contemporary regulatory frameworks increasingly adopt risk-based capital approaches in which capital requirements are tailored to the specific risk exposures of each company. These frameworks consider underwriting, investment, operational, and liquidity risks, requiring operators to maintain capital proportionate to the risks they assume. This approach enhances resilience by promoting a more adaptive and forward-looking capital structure compared to static minimum requirements (Bouafoula, 2021; Minimum Requirements, 2019).

Capital strength and effective solvency management are critical determinants of external credit ratings and industry rankings. Companies with robust capital adequacy are more likely to secure favorable ratings, which enhances investor confidence, reduces the cost of capital, and improves competitiveness. Conversely, weak capital positions may result in downgrades, thereby constraining access to funding and undermining the market reputation (Al Owaidhi, 2017; Takaful International, 2024). Hence, these dimensions highlight that capital in Takaful companies is not only a regulatory requirement, but also a strategic asset that defines perceptions of financial soundness, influences credit ratings, and supports long-term sustainability (Table 1).

Table 1. Financial Solvency and Capital Indicators in Takaful Companies

Indicator	Definition / Purpose	Importance for Takaful	Importance for Investors
Capital Adequacy Ratio (CAR)	Measures the company's ability to meet obligations and absorb losses.	Must account for commitment to qard hasan.	A key indicator of financial stability and the company's ability to honor commitments (Minimum Requirements, 2019).
Solvency Margin	The minimum required capital is mandated by regulatory frameworks.	Ensures compliance with regulatory requirements to protect participants.	Reduces regulatory intervention and enhances financial resilience (Minimum Requirements, 2019).
Risk-Based Capital (RBC)	Links capital requirements to the specific risks borne by the company.	Provides a more risk-sensitive measure, encouraging sound risk management (Bouafoula, 2021; Minimum Requirements, 2019).	Indicates a robust risk management framework, boosting investor confidence in the company's ability to manage exposures (Bouafoula, 2021).

Liquidity Ratio	Measures the company's ability to meet short-term obligations.	Critical for meeting claims and unexpected disbursements efficiently.	Signals the firm's ability to handle sudden liquidity needs and reassure policyholders (Bouafoula, 2021).
Return on Equity (ROE)	Measures profitability relative to shareholders' equity (AlJazira Capital, 2024).	Demonstrates efficiency in using shareholders' funds to generate profits.	A key metric for investor appeal and return on capital (Mubasher, 2025).
Return on Assets (ROA)	Measures efficiency of asset utilization in generating profits (AlJazira Capital, 2024).	Reflects the overall operational efficiency in deploying assets from both shareholders and participants.	Shows management efficiency in generating returns from asset base (AlJazira Capital, 2024).

(Source: Compiled by the Author)

2.6 Determining Solvency across Different Takaful Models

Although the principle of solvency is universally recognized, its assessment and practical application vary depending on the Takaful model employed. These differences reflect the structural distinctions in how each model allocates risks, manages capital, and safeguards participants' funds (Bouchada and Ouzazna, 2022).

In the Wakalah framework, solvency is primarily evaluated based on the strength of the operator's capital and its ability to manage the participants' funds effectively. A critical component is the operator's commitment to provide qard hasan (interest-free loans) in the event of deficits. This ensures the continuity of the participants' funds and supports the operator's capacity to meet claims obligations (Bouchada & Ouzazna, 2022). Under the Mudarabah arrangement, solvency assessments extend beyond the operator's capital base to include its share of investment risks. Since the operator participates in profits as a mudarib, it must demonstrate sufficient financial strength to withstand fluctuations in investment performance, while still guaranteeing the provision of qard hasan if deficits arise (Bouchada and Ouzazna, 2022). In the waqf model, solvency centers on the financial strength of the waqf fund. The fund is designed to be self-sustaining, but when deficits occur, it may be supported by the qard hasan extended from shareholders' capital. Importantly, the shareholders' capital and the waqf fund are managed separately, reflecting the trustee-like structure of this model (Bouafoula, 2021; Capital Market Authority Oman, 2019).

Therefore, across all Takaful models, solvency is measured using core financial indicators. These include capital adequacy ratios, liquidity ratios, and a company's ability to promptly settle claims. Such metrics provide regulators, rating agencies, and investors with standardized benchmarks for evaluating financial stability and resilience (Bouafoula, 2021; Minimum Requirements, 2019). In summary, these variations underscore that, while solvency remains a universal principle across Takaful, its interpretation and practical implementation are model-specific, reflecting the diverse mechanisms of risk-sharing and capital support within the industry.

3.0 Factors Attracting Capital Investment in Takaful Insurance Models

The attraction of capital to the Takaful sector is a multidimensional challenge that is influenced by a combination of market dynamics, regulatory support, financial performance, and ethical considerations. Unlike conventional insurance, Takaful must appeal not only to commercial investors but also to those who prioritize Shariah compliance and social responsibility. This dual requirement makes the identification of capital-attracting factors essential for the long-term sustainability of the industry.

3.1 Key Factors Influencing Capital Attraction in Takaful Companies

3.1.1 Market Growth Potential

The rapid expansion of the global Islamic finance industry and the presence of underserved Muslim communities have created significant opportunities for Takaful (IFAC, 2022). The sector benefits from strong market fundamentals, particularly where partnerships with international institutions reinforce its growth potential. Recent studies have highlighted the developmental role of Takaful in promoting financial inclusion

and reducing poverty (UNDP, 2024). International institutional support from Islamic development banks and cooperative financial institutions provides further assurance of the sectoral reliability. In addition, growing government recognition of Takaful's contribution to socio-economic development has fostered a favorable environment for capital inflows (IFAC, 2022; UNDP, 2024).

3.1.2 Legislative and Regulatory Environment

A transparent and supportive regulatory framework is critical for attracting both domestic and foreign investments. For instance, the Central Bank of Bahrain introduced a draft framework for assessing Takaful companies' capital adequacy based on underwriting activities, enabling firms to evaluate solvency in a Shariah-compliant manner. Such initiatives enhance investors' confidence by ensuring regulatory clarity and flexibility. Furthermore, regulatory approvals in new markets, such as the Philippines and Djibouti, have encouraged major firms to expand into these regions, signaling the growing global recognition of Takaful.

3.1.3 Financial Performance and Returns

Competitive financial performance is central to attracting capital. Investors seek companies with consistent profitability, strong returns on equity and assets, and competitive yields compared to conventional insurers (AlJazira Capital, 2024). Empirical evidence shows that the Takaful sector in Saudi Arabia, Malaysia, and Indonesia has experienced robust premium growth, outpacing conventional insurance markets. This trend demonstrates not only the resilience of Takaful but also its attractiveness as an investment avenue.

3.1.4 Governance and Transparency

Sound governance structures play a decisive role in shaping investors' perceptions. The inclusion of Shariah Supervisory Boards ensures compliance with Islamic principles, while transparent financial reporting enhances accountability (Bouafoula 2021; Takaful International 2024). Together, these mechanisms build credibility and reduce information asymmetry, thereby strengthening investor confidence.

3.1.5 Strong Solvency and Risk Management

Capital adequacy and risk management are the crucial determinants of financial stability. Well-capitalized Takaful operators with effective risk management frameworks demonstrate resilience against unexpected shocks, thereby reducing perceived investment risks (Minimum Capital Requirements, 2019). This enhances the sector's ability to compete with conventional insurers in global markets.

3.1.6 Shariah Compliance

Adherence to Shariah principles constitutes the core value proposition of Takaful. By prohibiting interest (riba), uncertainty (gharar), and excessive risk-taking (maysir), Takaful appeals to both faith-driven and ethical investors (Mohammed and Bouhlit 2018; Arqam 2023). Moreover, its alignment with Environmental, Social, and Governance (ESG) principles, particularly the emphasis on ethical investment and harm avoidance, positions Takaful as an attractive option for ESG-conscious investors (PwC, 2022).

3.1.7 Social Dimension

The cooperative and socially responsible foundations of Takaful enhance its appeal as an ethical investment vehicle. This model emphasizes fairness, mutual protection, and community well-being (Omar and Dawood, 2000). Unlike conventional emphasis on high-risk, high-return strategies, Takaful offers investors the opportunity to achieve halal profits in a structured and secure environment. This ethical dimension strengthens its role as a mechanism of collective resilience, particularly during emergencies and global crises.

3.1.8 Innovation through Fintech

Recent advances in digital innovation have further enhanced Takaful's investment appeal. The integration of fintech has enabled the development of innovative products and modern distribution channels, particularly through digital platforms. These advancements have improved accessibility, reduced costs, and attracted a new generation of tech-savvy investors (Qatafi and Allali 2021). Fintech solutions thus play an increasingly strategic role in expanding Takaful's reach and efficiency.

In summary, these factors illustrate that attracting capital to Takaful requires more than just financial competitiveness. This requires a holistic approach that integrates market potential, sound governance, regulatory clarity, and adherence to ethical values. By aligning financial sustainability with social responsibility and innovation, the Takaful sector has strengthened its position as a viable and attractive alternative within the global financial system.

3.2 Challenges in Capital Compliance with Financial Regulations and Standards

Takaful companies operate at the intersection of Shariah compliance and global financial regulation, a dual framework that presents distinctive challenges to capital growth and sustainability. While adherence to Islamic principles provides a strong ethical foundation, it also imposes constraints that interact with evolving international financial standards and competitive pressure. The major challenges are as follows:

3.2.1 Compliance Costs

Ensuring full alignment with the Shariah principles entails additional operational expenditures compared to conventional insurers. Takaful operators are required to establish and maintain Shariah Supervisory Boards (SSBs), which oversee compliance with Islamic jurisprudence across underwriting, investment, and governance activities (Bounchada and Ouzazna 2022). These oversight structures, while critical for legitimacy and investor trust, increase the administrative and governance costs. Over time, such costs may reduce profitability and weaken the comparative attractiveness of the Takaful firms to potential capital providers.

3.2.2 Multiplicity of Fatwas and the Need for a Unified Shariah Reference

Differences in jurisprudential interpretations across jurisdictions have created a fragmented Shariah landscape. What is deemed compliant in one country may be contested in another, complicating international expansion and cross-border capital raising (Bouafoula, 2021; Oman Capital Market Authority, 2019). This multiplicity of fatwas not only slowed product innovation, but also raised uncertainty for global investors. Scholars have increasingly called for greater harmonization and the development of unified Shariah references to ensure consistency and predictability in Takaful operations.

3.2.3 Limited Availability of Shariah-Compliant Instruments

A key challenge for Takaful companies is the limited depth and liquidity of the Shariah-compliant financial markets. Investment options such as sukuk, Islamic equities, and Shariah-compliant funds remain comparatively constrained in terms of volume and diversity (Oman Capital Market Authority 2019). This restricts the ability of operators to optimize capital deployment, balance risk-return profiles, and compete with conventional insurers that have access to broader and higher-yielding instruments. The lack of diversification opportunities increases investment concentration risks and limits growth potential.

3.2.4 Regulatory Adaptation

The global financial sector is characterized by constant evolution in accounting standards, solvency regimes, and prudential requirements. For instance, the adoption of risk-based capital frameworks and international accounting standards (such as IFRS 17 for insurance contracts) demands significant expertise and investment in systems, training, and compliance infrastructure (Minimum Capital Requirements, 2019; Bouafoula, 2021). For many Takaful operators, particularly in emerging markets, these transitions impose financial and human resource strain, potentially slowing growth and innovation.

3.2.5 Competition from Conventional Insurers

Takaful firms frequently compete against larger and more established conventional insurers that enjoy economies of scale, diversified product portfolios, and wider distribution channels (Al-Owaidi, 2017). While Takaful differentiates itself through ethical and Shariah-based value propositions, conventional insurers often attract investors by offering better financial performance and lower operational costs. This competitive imbalance may deter capital inflows into the Takaful sector unless operators innovate and highlight their unique value-added features such as ESG alignment and community-oriented protection.

In summary, Takaful companies face a complex set of challenges in capital mobilization rooted in the dual necessity of meeting Shariah compliance requirements while adapting to international financial standards and market competition. High compliance costs fragmented jurisprudential interpretations, limited Shariah-compliant instruments, regulatory pressures, and strong competition from conventional insurers, collectively constraining capital attraction. Overcoming these challenges will require the harmonization of Shariah interpretations, greater innovation in Islamic financial instruments, and strategic positioning to highlight Takaful’s ethical and social advantages within the broader financial ecosystem (Table 2).

Table 2. Takaful vs Conventional Insurers

Aspect	Takaful Companies	Conventional Insurers
Compliance Costs	Must maintain Shariah Supervisory Boards and additional governance processes to ensure compliance with Islamic principles, which increases operational costs.	No Shariah compliance required; lower governance-related expenses.
Shariah Governance	Subject to jurisprudential diversity across jurisdictions, leading to variations in fatwas and potential complexity in cross-border operations.	Operate under standardized global insurance and financial regulations without religious governance considerations.
Investment Instruments	Limited to Shariah-compliant assets, restricting diversification and potentially lowering yield.	Broad access to conventional financial instruments, including bonds and derivatives, offering greater flexibility and returns.
Regulatory Adaptation	Must comply with both international financial standards (IFRS, solvency regimes) and Shariah guidelines, requiring significant expertise and dual compliance frameworks.	Compliance limited to conventional accounting and solvency standards without additional religious requirements.
Competition	Face structural disadvantages compared with larger conventional insurers, including limited economies of scale and narrower product offerings.	Benefit from established market presence, scale efficiencies, and diversified products.

(Source: Compiled by Author)

4.0 Research Methodology

This study adopts a qualitative, exploratory design using secondary sources and comparative case analysis to investigate capital inflow strategies in Takaful insurance. A qualitative exploratory design is appropriate because the research seeks to interpret policies, governance arrangements and market behaviour across different Takaful models rather than test hypotheses. Secondary documentary sources such as regulatory texts, annual reports, industry/consultancy reports, and academic literature were used to capture regulatory and market developments across jurisdictions, and permit a cross-case comparison of capital-attracting strategies. International case studies were selected purposively to ensure relevance, variation and data availability. The following inclusion criteria were applied:

1. Market significance: country has a sizeable or fast-growing Takaful market (e.g., leading contribution levels, recent premium growth) or is otherwise important to the international Takaful landscape.

2. Regulatory innovation or recent reforms: evidence of recent policy or regulatory activity affecting capital, solvency or Shariah governance.
3. Model diversity: representation of different operational models (Wakalah, Mudarabah, Hybrid, Waqf) where possible.
4. Data availability and transparency: presence of publicly available, authoritative documents (regulator publications, company annual reports, credible industry reports) in English or translated to English.
5. Geographical and institutional variety: selection aims to include markets from different regions to improve external validity.

Using these criteria, the study gave priority to jurisdictions that meet multiple criteria (e.g., Malaysia, Saudi Arabia and the UAE), and then selected additional jurisdictions for comparative examples where documents satisfied the inclusion rules.

5.0 Results and Discussion

5.1 The Role of the Legislative and Regulatory Environment

A central finding from the case studies is that clear and well-designed legislative and regulatory environments significantly enhance the attractiveness of Takaful to investors. In Malaysia, the enactment of the Takaful Act (1984) and subsequent updates under Bank Negara Malaysia created the earliest and most comprehensive governance framework for Takaful. The emphasis on strong Shariah governance, mandatory Shariah Supervisory Boards (SSBs), and gradual reforms, such as the Risk-Based Capital Framework (RBC-T), has steadily built investor confidence (Bank Negara Malaysia, 2018; Funding Souq, 2024). In Saudi Arabia, regulatory momentum under the Saudi Arabian Monetary Authority (SAMA), particularly the introduction of compulsory health and motor Takaful, generated substantial gross written premiums and created a strong demand. This compulsory coverage framework not only attracted sustained capital inflows but also contributed to national economic growth through insurance penetration (Al-Owaidi, 2017; Al-Sharqi et al., 2022). Similarly, the United Arab Emirates (UAE) leveraged its advanced legislative infrastructure, including liberalized foreign investment laws, to attract foreign direct investment (FDI) in the insurance sector. By combining regulatory clarity with a business-friendly environment, the UAE has positioned itself as a regional hub for Takaful investments (Ministry, 2022). Taken together, these experiences demonstrate that transparent and supportive legislation reduces uncertainty, facilitates cross-border expansion, and reassures investors. The practical implication is that countries seeking to strengthen their Takaful sectors must prioritize customized Shariah-compliant regulatory frameworks rather than relying on adapted conventional insurance models.

5.2 Solvency, Capital Adequacy, and Investor Confidence

Capital strength and solvency emerged as critical determinants of investor confidence in the examined case studies. In Malaysia, the transition from static capital requirements to the Risk-Based Capital Framework for Takaful (RBC-T) linked solvency measures directly to actual risk exposures, aligning local practices with global standards and reassuring investors of the sector's resilience to financial shocks. In Saudi Arabia, rapid premium growth driven by compulsory health and motor Takaful schemes strengthened solvency margins and profitability, which, in turn, elevated sectoral credit ratings and attracted significant institutional capital. In the United Arab Emirates (UAE), regulators emphasized capital adequacy as a strict precondition for licensing foreign insurers, ensuring that solvency safeguards were in place while simultaneously enabling foreign capital inflows. Collectively, these cases demonstrate that solvency frameworks function not only as regulatory compliance mechanisms but also as strategic tools for enhancing market credibility. By linking capital adequacy to risk exposure, regulators can provide stronger assurances to investors regarding the Takaful industry's long-term stability and sustainability.

5.3 Governance, Transparency, and Shariah Compliance

Governance quality, transparency, and Shariah compliance are decisive factors shaping investors' perceptions of Takaful. Malaysia has institutionalized strong governance mechanisms by mandating Shariah Supervisory Boards (SSBs) for all licensed operators, thereby reinforcing credibility and market confidence through independent compliance and disclosure oversight. In Saudi Arabia, while compulsory coverage stimulated rapid premium growth, the expansion also revealed governance challenges, as operational capacity sometimes

lagged behind market growth, raising concerns regarding efficiency and oversight. In contrast, the United Arab Emirates (UAE) emphasizes transparent reporting and adherence to international accounting standards, such as IFRS 17, aligning local operators with global best practices while maintaining Shariah compliance. These examples illustrate that effective governance reduces information asymmetry, enhances credibility, and strengthens both participant trust and investor confidence in the market. Accordingly, transparent disclosure practices combined with credible Shariah oversight are essential for ethical legitimacy and attracting and sustaining foreign capital inflows into the Takaful sector.

5.4 Financial Performance and Returns

Competitive financial performance was identified as a core driver of investor interest across the case studies, demonstrating that capital inflows are closely tied to profitability and return. In Saudi Arabia, major Takaful operators, such as Al Rajhi Takaful and Bupa Arabia, reported strong profitability and double-digit returns on equity, positioning the sector as an attractive destination for institutional investors. Malaysia, characterized by more moderate growth, provided steady and reliable returns supported by regulatory consistency and market stability, which appealed to investors seeking lower-risk, long-term opportunities. In the United Arab Emirates (UAE), operators leverage diversified portfolios and foreign investment inflows to achieve competitive financial outcomes, with robust solvency and transparency further reinforcing their appeal. Collectively, these findings indicate that investors evaluate Takaful not only on its ethical and Shariah-compliant foundations but also on its ability to deliver consistent, risk-adjusted financial returns. Profitability metrics, such as return on equity (ROE), return on assets (ROA), and solvency ratios, serve as critical benchmarks for signaling the investment attractiveness of Takaful operators.

5.5 Innovation and Fintech Integration

Innovation and fintech integration have emerged as transformative factors in mobilizing capital and enhancing the competitiveness of Takaful across different jurisdictions. In Malaysia, operators have pioneered the use of digital platforms and micro-Takaful products to expand their outreach and reduce distribution costs, thereby strengthening financial inclusion. The UAE has advanced further by adopting insurtech solutions, such as mobile platforms and digital policy management systems, which have improved operational efficiency and facilitated broader market participation. Saudi Arabia has increasingly embraced digital distribution channels, although their integration remains uneven across operators, highlighting the potential for further growth. These experiences collectively illustrate that fintech not only reduces costs and increases scalability, but also enhances investor appeal by modernizing service delivery and aligning the sector with global trends in digital finance. Consequently, fintech integration can be considered a strategic enabler for attracting new categories of capital, particularly from technology-oriented and ESG-conscious investors.

5.6 Practical Lessons from International Case Studies

A comparative analysis of Malaysia, Saudi Arabia, and the United Arab Emirates (UAE) highlights several practical lessons for strengthening capital inflows into Takaful (Table 4). Malaysia's experience underscores the value of gradual regulatory evolution, where consistent reforms, strong Shariah governance, and risk-based solvency frameworks have created a stable environment for long-term investments. Saudi Arabia demonstrates that compulsory coverage schemes, particularly in health and motor Takaful, can generate rapid premium growth and attract substantial capital inflows, although these must be matched with robust governance systems to ensure sustainability. The UAE illustrates how investor-friendly policies, advanced legislative infrastructure, and alignment with international financial standards can position a jurisdiction as a regional hub for Takaful investments. Together, these lessons suggest that capital mobilization in Takaful requires a combination of regulatory clarity, governance credibility, market innovation, and institutional support tailored to the context of each jurisdiction.

Table 4. Comparative International Experiences in Attracting Capital for Takaful Development

Country	Regulatory & Legislative Framework	Key Drivers of Capital Attraction	Impact on Takaful Growth & Investment
Malaysia	Islamic Financial Service Act (1984) and subsequent updates under Bank Negara Malaysia	Comprehensive regulatory framework, strong Shariah governance, gradualist regulatory approach, continuous product and capital market innovation	Positioned as a global leader in Islamic finance; steady inflows of domestic and foreign capital; enhanced investor confidence through Shariah governance reforms
Saudi Arabia	Compulsory insurance regulations; reforms under Saudi Arabian Monetary Authority (SAMA)	Largest Takaful market by gross contributions; regulatory momentum; mandatory health and motor insurance driving demand	Significant capital inflows; premium growth outpacing conventional insurance; positive contribution to GDP and sectoral investment levels
United Arab Emirates (UAE)	Advanced legislative infrastructure and foreign investment laws	Business-friendly environment; investor-focused reforms; strong FDI orientation	Increasing foreign direct investment into Takaful; improved competitiveness of the sector within the MENA region

(Source: Compiled by Author)

5.7 Synthesizing Practical Insights

Synthesizing the evidence across the case studies reveals that capital inflows into Takaful are shaped by the interplay of regulatory quality, solvency strength, governance practices, financial performance, and tech innovation. Transparent and harmonized regulations have emerged as the foundation for investor confidence, while robust solvency frameworks and risk-sensitive capital adequacy requirements signal resilience against financial shocks. Governance mechanisms, particularly Shariah Supervisory Boards and transparent reporting standards, reduce information asymmetry and enhance legitimacy, further strengthening investor trust. Simultaneously, profitability indicators, such as return on equity and return on assets, confirmed the sector's competitiveness relative to conventional insurers, while fintech integration broadened access and lowered costs, positioning Takaful as both an ethical and innovative investment option. The practical insight from these findings is that policymakers, operators, and investors must view capital not merely as a compliance requirement but also as a strategic resource. By aligning regulation, governance, and innovation with the ethical mission of Takaful, the industry can attract sustainable investment, enhance its resilience, and position itself as a viable and socially responsible alternative to the global financial system.

6.0 Conclusion and Recommendations

This study examined the dynamics of capital inflows in Takaful through a qualitative analysis of international case studies in Malaysia, Saudi Arabia, and the United Arab Emirates (UAE). The findings demonstrate that capital is not merely a financial requirement but a strategic enabler of solvency, resilience, and long-term sustainability in the Takaful industry. Across contexts, five interlinked themes emerged as decisive in shaping investor confidence: regulatory clarity, solvency and capital adequacy, governance and Shariah compliance, financial performance, and innovation through Fintech integration. These themes reveal that effective capital mobilization depends on aligning regulatory safeguards with market incentives and ensuring that the distinctive principles of Takaful are not diluted when adapted to global financial frameworks.

Malaysia's gradual reforms, including the Risk-Based Capital Framework for Takaful (RBC-T), demonstrate how consistent regulatory evolution and strong Shariah governance can generate stable investment inflow. Saudi Arabia illustrates how compulsory health and motor insurance schemes can rapidly increase premiums and attract capital, but they must be complemented by robust governance mechanisms to ensure sustainability. The UAE highlights the importance of investor-friendly legislation and integration with international accounting and reporting standards, positioning itself as a regional hub for foreign direct investment in Takaful. Together, these cases confirm that while pathways may differ, the underlying drivers of capital mobilization are consistent: solvency assurance, governance legitimacy, and credible profits.

A further dimension of the findings is the close alignment between Takaful principles and the Environmental, Social, and Governance (ESG) framework, which is increasingly prioritized by global investors. Takaful's cooperative and risk-sharing ethos directly reflects the social pillar of ESG by promoting solidarity, financial inclusion, and mutual protection. Its prohibition of unethical or speculative investments, coupled with oversight by Shariah Supervisory Boards, reinforces the governance pillar by institutionalizing transparency and accountability. Moreover, the sector's growing role in financing sustainable Shariah-compliant initiatives, such as healthcare and renewable energy, demonstrates its potential contribution to the environmental pillar. This synergy positions Takaful not only as a faith-based alternative but also as a natural partner in advancing the global sustainability agenda.

Based on these findings, several recommendations are proposed. For policymakers, the priority should be to develop harmonized, Shariah-compliant regulatory frameworks that integrate risk-based capital standards with supportive measures, such as tax incentives and innovation-friendly policies. Regulators should also strengthen disclosure requirements and align them with international standards, such as the IFRS 17, to enhance investor comparability and confidence. Takaful operators must focus on improving governance structures, diversifying investment portfolios, adopting fintech solutions to enhance efficiency, and reducing dependence on qard hasan as a source of deficit financing. Investors should recognize the dual advantage of Takaful: competitive financial returns and alignment with ESG criteria, which increasingly shape global investment strategies.

Future research should build on these insights by employing quantitative methods to measure the impact of specific regulatory or technological reforms on capital inflows and by exploring the role of emerging tools such as blockchain and artificial intelligence in strengthening governance and transparency.

In conclusion, the evidence demonstrates that capital mobilization in Takaful is most effective when it integrates regulatory clarity, robust solvency standards, strong governance, financial innovation and ESG alignment. By leveraging these factors, Takaful can consolidate its position as a resilient, competitive, and socially responsible alternative to the global financial system.

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The Role of Islamic Social Finance in Strengthening Islamic Microfinance Institutions for Poverty Alleviation in Nigeria: A Synergistic Conceptual Framework

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Abstract

Microfinance is an effective method for combating poverty. It offers access to financial resources to reduce poverty by promoting financial engagement and empowerment. Therefore, microfinance is considered a worthy circle for breaking the poverty chain. As of 2022, over 800 microfinance banks operate to drive the government's poverty reduction initiatives in Nigeria. However, the primary goal of poverty eradication has yet to be achieved. This research aims to propose a novel synergistic scheme that empowers existing Islamic microfinance through Islamic social finance resources, such as Zakat, Waqf, and Sadaqat, to increase financial outreach in Nigeria through the new Credit-Plus concept. It includes a comprehensive Shariah-compliant product, integrating multiple Islamic Microfinance and Islamic Social Finance products, such as Microcredit, Microdeposit, zakat funds, and waqf properties, along with entrepreneurship training, into one effective poverty intervention scheme. This study applies Igor Ansoff's synergy theory to develop a synergistic conceptual framework for identifying commonalities and assessing the need for collaboration between Islamic Social Finance and Islamic Microfinance in Nigeria, with the aim of working together to alleviate poverty in the country. It is expected that if this model is appropriately implemented, it could be a milestone in effectively reducing the poverty rate in Nigeria and ultimately bringing prosperity and upliftment to the country's impoverished populations.

Keywords: Islamic Microfinance, Islamic Social Finance, Nigeria, Credit-Plus Concept.

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1. Introduction

According to the [National Bureau of Statistics \(2023\)](#), over 133 million Nigerians—representing approximately 63% of the population—are classified as multidimensionally poor. This staggering figure underscores the severity of poverty in the country and highlights the urgent need for inclusive financial solutions. Microfinance is an effective method in combating poverty, as it provides access to financial resources that can aid poverty reduction by promoting financial engagement and empowerment. However, the [National Bureau of Statistics \(2023\)](#) statistics show that Nigeria's microfinance institutions support fewer than one million out of 40 million potential borrowers. Furthermore, microcredit facilities in Nigeria account for just 0.2% of the GDP and less than 1% of total credit to the economy. Therefore, an ineffective solution to resolve the situation will exacerbate poverty while slowing growth and development, according to the [NBS \(2023\)](#). As of 2019, over 800 microfinance banks operate to drive the government's poverty reduction initiatives in Nigeria ([National Bureau](#)

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of Statistics, 2020). However, the primary goal of poverty eradication has yet to be achieved. Alternatively, the existing literature has identified Islamic microfinance banks and institutions as a feasible solution to alleviate poverty in Nigeria.

Nevertheless, some factors still hinder the development of Islamic microfinance banks in Nigeria. [Salaudeen and Zakariyah \(2022\)](#) identified several operational challenges in Islamic microfinance, including share capital (funding), lack of awareness, inadequate Islamic financial technology for retail services, limited access for the unbanked, misconceptions, and human resources, which impede financial inclusion. On the other hand, Islamic social finance also embarked on the financial inclusion mission through Islamic poverty alleviation schemes such as Zakat, Waqf, and Qard Hasan. However, [Saad and Farouk \(2019\)](#) revealed that the fragmented implementation of the Zakat and Waqf system within the Nigerian financial system led to weak governance and outreach, as well as feeble administration and management of the two institutions. Furthermore, the absence of Zakat accounting standards and low compliance behaviour are the significant barriers that require the government's attention and other stakeholders, such as the traditional leaders, the accounting regulatory bodies, the Shari'ah scholars ('Ulamas) and the economic and accounting researchers ([Saad & Farouk, 2019](#)).

This research introduces a groundbreaking, synergistic approach to improve financial outreach in Nigeria through the implementation of the Credit-Plus concept. It enhances existing Islamic microfinance by leveraging Islamic social finance resources such as Zakat, Waqf, and Sadaqat. The initiative offers a comprehensive product that adheres to Shari'ah principles, integrating various Islamic social finance and microfinance services into a single effective programme to fight poverty, including microcredit, micro-deposit, Zakat funds, Waqf properties, and entrepreneurship training. This model applies Igor Ansoff's synergy theory to develop a synergistic framework for identifying shared features and evaluating the necessity of collaboration between Islamic Social Finance and Islamic Microfinance in Nigeria, with the aim of working together to reduce poverty in the country.

This study has made a significant contribution by opening up a new academic path for researching financial inclusion in Nigeria, particularly the Islamic poverty alleviation scheme. Moreover, this research has made a valuable empirical contribution to academia by investigating the complementary relationships between Islamic economic institutions, such as Islamic social finance and Islamic microfinance, their inclusive products and services, and how they can effectively utilise resources to alleviate poverty sustainably. Additionally, this study has offered existing Islamic microfinance institutions and Islamic social finance organisations a practical solution to tackle their internal challenges and maximise their financial and social impact with limited resources. The research structure comprises an introduction, literature review, theoretical and conceptual framework, Credit-Plus concept, findings, recommendations, and conclusion.

2. Literature Review

In 2022, Nigeria was home to approximately 12% of the global population living in extreme poverty, defined as those living below the poverty threshold of \$ 1.90 per day ([World Bank, 2020](#)). Additionally, the Democratic Republic of the Congo constituted approximately 10% of the worldwide population living in conditions of extreme poverty. Tanzania, Madagascar, and Mozambique are African nations with significantly impoverished populations.

Microfinance is an effective method of combating poverty because it offers access to financial resources that can aid in poverty reduction by promoting financial engagement and empowerment. Therefore, microfinance is considered a worthy circle for breaking the poverty chain. ([Beck, 2015](#)) As of 2019, over 800 microfinance banks operate in Nigeria, supporting the government's poverty reduction initiatives ([Abdullahi & Othman, 2021](#)). However, the primary goal of poverty eradication has yet to be achieved. Nevertheless, the existing literature has identified Islamic microfinance banks and institutions as a feasible solution to alleviate poverty in Nigeria. However, some factors still hinder the expansion of Islamic microfinance banks across Nigeria, including funding, fintech, awareness, and others. ([Haruna and Ayuba, 2015](#); [Salaudeen and Zakariyah, 2022](#)). On the other hand, Islamic social finance also embarked on the financial inclusion mission through Islamic poverty alleviation schemes such as Zakat, Waqf, and Qard Hasan ([Ahmad, 2019](#)).

In Nigeria, implementing Islamic microfinance is a matter of equity and social justice, according to [Al-Ameen \(2016\)](#). He highlighted the need for Muslims to have access to a robust Islamic microfinance system as well as how Muslims in Nigeria were shut out of the microfinance industry when the sector was founded and established. Because many low-income Muslims who require microcredit cannot take advantage of government

microcredit programmes, [Al-Ameen \(2016\)](#) explored the need for an Islamic MFB for the Nigerian Muslim population. After all, the loan conditions contradict what people hold to be true. However, operational challenges impede Islamic microfinance organisations' efforts to achieve long-term financial inclusion, as argued by [Al-Ameen \(2016\)](#).

[Gumel et al. \(2014\)](#) aimed to explore how Islamic microfinance products can help alleviate poverty in Malaysia's northern region. The study utilised borrowers of Islamic loans from a select group of microfinance institutions in the Nigerian states of Jigawa and Kano. According to the findings of this study, Islamic microfinance interventions have significantly improved children's education, asset acquisition, and household income.

According to data gathered by [Zauro et al. \(2020\)](#) from secondary sources like the Al-Qur'an, Hadiths, and other empirical studies in the literature, the combination of waqf and microfinance institutions could foster financial inclusion in Northern Nigeria, encourage economic growth, and advance the socio-economic development of Nigeria as a whole. The study suggests that, as a means of achieving socioeconomic justice in Nigeria's Muslim community, which is adversely impacted by the high rate of poverty and financial exclusion, the creation of Waqf funds to support the less fortunate through Islamic Microfinance is a viable option. However, the researcher does not clearly explain the study methodology.

Al-Hayat Relief Foundation is Nigeria's most prominent Islamic microfinance institution in six states. Al-Hayat was established to encourage the provision of interest-free loans to its registered members by using the Islamic economic system on a case-by-case basis ([Salaudeen & Zakariyah, 2022](#)). As a microfinance organisation, Al-Hayat Relief Foundation has proactively alleviated poverty among the Muslim population through several interrelated strategies ([Adepoju & Oyesanya, 2014](#)). This foundation also offers the customers training in Islamic financial literacy ([Adepoju & Oyesanya, 2014](#)). [Salako and Azeez \(2018\)](#) also employed a descriptive survey method to assess the social and economic impacts of Al-Hayat Relief Foundation's members. The instrument utilised to collect data was a self-made questionnaire. The data gathered from the survey replies were examined using a descriptive analysis. Pearson's correlation analysis was used with the SPSS 2011 version package to validate null hypotheses. According to the findings of this study, the Al-Hayat Relief Foundation significantly contributes to the economic and social well-being of the populace, and its programmes are, up to a reasonable degree, Shari'ah-compliant.

Subsequently, several challenges still hinder Islamic Social Finance (ISF) from achieving notable financial inclusion in Nigeria. [Saad and Farouk \(2019\)](#) note that Zakat and Waqf institutions in Nigeria have not attained their inherent Shari'ah objectives because public members have little or no trust or confidence in them. Additionally, potential zakat payers and waqf donors dislike the involvement of political officeholders in appointing the administrators of these institutions. Finally, the administrators lack adequate managerial and administrative knowledge.

[Mikail et al. \(2024\)](#) argued that the COVID-19 pandemic, which has been devastating recently, caused numerous issues for human society. Since Islamic microfinance programmes and various social enterprises aim to address social problems through entrepreneurial approaches while remaining operationally self-sufficient and sustainable, they could be utilised, like many other development initiatives, to restore the socio-economic fabric ravaged by the pandemic. Therefore, it is logical that integrating ISFs with Islamic microfinance institutions and social enterprises will enhance their performance and support economic recovery. This will inevitably lead to the empowerment of the impoverished beneficiaries of Islamic microfinance initiatives. [Haruna et al. \(2015\)](#) and [Ascarya et al. \(2023\)](#) also suggested that combining Islamic microfinance with zakat and waqf, the traditional means of aid to the poor, can foster sustainable economic growth and development.

3. Methodology

This research employed an epistemological interpretivism approach as its paradigm. Unlike positivism, which views reality as objective and measurable, interpretivism suggests that reality is subjective, socially constructed, and shaped by different perspectives. Through this lens, the researcher acknowledges their influence on the research process, as their personal experiences and previous studies inform their interpretation of observed phenomena ([Agee, 2009](#)). In contrast to this approach, previous studies—such as those by [Abubakar \(2014\)](#), [Oluyombo and Ogundimu \(2017\)](#), and [Salaudeen and Zakariyah \(2022\)](#)—have adopted positivist and realist methods to examine the potential and challenges of Islamic microfinance and Islamic social finance systems in Nigeria.

Furthermore, this research utilises Igor Ansoff's synergy theory to develop a synergistic conceptual

framework aimed at identifying commonalities and assessing the need for collaboration between Islamic social finance and Islamic microfinance in Nigeria. The goal is to work together to alleviate poverty in the country. It is anticipated that if this model is effectively implemented, it could mark a significant achievement in reducing the poverty rate in Nigeria and ultimately contribute to enhancing the welfare of its impoverished populations.

As highlighted by [Othman et al. \(2024\)](#), establishing a well-structured synergy between Islamic social finance solutions and existing Islamic microfinance programmes can boost the financing capabilities of current microfinance providers. This study proposes using Ansoff's synergy theory as the most appropriate framework. Additionally, this approach can reduce overall risks faced by Islamic microfinance institutions and foster long-term organisational innovation. By leveraging social finance tools such as zakat, infaq, and waqf, these institutions can create new, more appealing products for the market, helping potential customers break free from the cycle of poverty.

4. Theoretical and Conceptual Framework

The following theories are applied in the current study, confirming that it is grounded in established theories and concepts.

4.1 Financial Inclusion Theories

As mentioned by [Ozili \(2020\)](#), the availability and accessibility of fundamental financial services to all public members is financial inclusion. When people and businesses have access to cost-effective financial services and products that meet their requirements in an ethical and sustainable manner, they are considered financially included. The practices used for financial inclusion vary from nation to nation, so it is crucial to identify the guiding ideas or hypotheses that underlie these differences. Theories of financial inclusion provide meaning to the actions of financial inclusion. A theory of financial inclusion is required to attain a high degree of synthesis between financial inclusion outcomes and objectives. A theory or collection of theories on financial inclusion would provide a framework for understanding the goals, processes, and outcomes of financial inclusion. Furthermore, financial inclusion theories might combine the current idealistic discussions in the policy literature on financial inclusion ([Ozili, 2020](#)).

In addition to providing a foundation of principles upon which the practice of financial inclusion can be built, the theories of financial inclusion can also be used to identify unusual patterns in financial inclusion practice, thereby stimulating further investigation into the reasons behind practice deviations. Researchers in the social sciences often use one or more theories to analyse and solve problems while undertaking research motivated by specific issues ([Aburime, 2008; Ozili, 2020](#)).

This suggests that the ideas applied to explain a problem of financial inclusion may not match those used to offer viable solutions. The theoretical frameworks for identifying beneficiaries of financial inclusion and financing and implementing financial inclusion efforts may also vary ([Inoue & Hamori, 2014](#)). The good public theory, dissatisfaction theory, vulnerable group theory, systems theory, community echelon theory, public service theory, special agent theory, collaborative intervention theory, financial literacy theory, private money theory, public money theory, and the intervention fund theory are a few of the theories of financial inclusion that [Ozili \(2020\)](#) identified. This study's financial inclusion ideas presented in this study will benefit researchers, scholars, policymakers, and practitioners.

4.1.1 Public good theory of financial inclusion

According to the public good theory of financial inclusion, providing formal financial services to the entire population and guaranteeing that no one faces limitations on their access to finance should be considered a public good that benefits all individuals in the community. All individuals in the community. People cannot be prohibited from using or accessing formal financial services, as they are a public benefit. Essential financial services will be available to everyone without charge. This notion holds that everyone benefits from financial inclusion, and no one is left out. Financial services are not less accessible to others when they are accessed by one person, which implies that everyone can benefit from increased participation in the formal financial system. Any person or small business that opens a formal bank account may be eligible for free debit cards under the public good premise. They may also use automated teller machines (ATMs) to conduct transactions without paying a fee. As a sunk cost of conducting business in the banking industry, financial service providers, such as financial institutions, will also be responsible for covering the cost of providing financial services ([Ozili, 2020; Khan & Khan. 2024](#)).

4.1.2. *Change theory of financial inclusion*

Expectations about how impoverished people should profit from interacting with finance have shifted due to financial inclusion. The "original" (microcredit) theory of change postulated that the higher profits from entrepreneurial endeavours made possible by microloans would reduce poverty. In contrast, the change theory of financial inclusion is unconcerned with entrepreneurship and is centred on two types of financial intermediation: intertemporal and interspatial-interclass. Intertemporal intermediation is based on the theory that a significant economic issue facing low-income individuals, who frequently have irregular incomes, is how to effectively manage their cash flow between periods of financial abundance and times of need. According to the theory, financial services enable individuals to reallocate their expenditures over time. This implies that when one's current income is insufficient to cover expenses, one can use past, future, or a combination of income sources (Mader, 2018). Financial services are therefore suggested to reduce poverty from a microeconomic perspective by moving money across time. A macro-level theory known as "interspatial-interclass intermediation" holds that finance stimulates economic growth by dividing capital and risk and reducing transaction costs. Capital is moved by finance from places and people with excess capital to places and people needing capital; the more robust the connections between these locations and individuals, the greater the growth arising from economic exchanges. Therefore, from a macroeconomic perspective, financial inclusion brings together more capital providers and users to drive economic growth, benefiting the impoverished (Khan & Khan, 2024).

4.1.3. *Vulnerable group theory of financial inclusion*

According to the vulnerable group theory of financial inclusion, a nation's financial inclusion initiatives and programs should prioritise the most vulnerable members of the population, including the elderly, children, women, and the impoverished, as they bear the brunt of financial stress and crises. Since financial crises and economic downturns frequently impact vulnerable individuals, including them in the formal financial system makes sense, as highlighted by Ozili (2020). Government-to-person (G2P) social cash transfers into the official accounts of vulnerable people are one technique to achieve this. Paying G2P social cash transfer benefits into the formal accounts of impoverished women and the elderly may catalyse other impoverished women and elderly individuals to enter the formal financial sector and open formal accounts to benefit from G2P social cash transfer benefits. This could lead to an increase in the financial inclusion of vulnerable groups. Since financial crises and economic downturns frequently impact vulnerable individuals, including them in the formal financial system makes sense (Anand & Chhikara, 2013).

4.2. *Synergistic Effect Concept*

When two or more entities operate together, their combined efforts can have a more significant overall effect than if each entity functioned individually. This is known as synergism. As Hron and Macak (2013, p. 498) mentioned, "*Synergism is an interaction between two or more agents, entities, factors, or substances that produces an effect greater than the sum of their individual effects. Also called the synergetic effect or synergistic effect, it is the opposite of antagonism.*"

For example, when two individuals simultaneously apply pressure on the same side of a heavy door, the door will open more quickly than if they worked separately—moreover, the combination of the entities in synergy and synergism results in a synergistic effect. When two or more entities come together, their combined influence is said to be synergistic since it exceeds the sum of their separate effects. As Tallarida (2011, p. 1003) pointed out, "When the combined effect is greater than that predicted by their potencies, the combination is said to be synergistic."

4.2.1. *Igor Ansoff (1965) and Michael E. Porter (1985) Synergy theories*

The question of what businesses should do to enhance their business value and gain a competitive edge has been the focus of a substantial amount of strategic management studies over the years. When two products or marketplaces come together, Igor Ansoff coined the phrase "synergy effect" in the 1960s to describe the general impacts that result. The central concept was that an increased value, which could not be obtained separately, might result from the combined effects (Raluca, 2011).

Igor Ansoff defines synergy as the outcome of the two resources working together that is larger than the sum of their contributions. Sales, managerial, operational, and investment synergies are the four forms of

synergy he covers. Ansoff argued that businesses that can leverage advantages in their core competencies through market diversification on well-chosen fronts are the most prosperous. The benefits of synergy may then result from this diversification (Raluca, 2011). However, Ansoff also opined that Synergies would be minimal or may be detrimental if the plan is poorly executed (Raluca, 2011).

Again, according to Porter's (1985) argument, diversified organisations with synergy have a competitive advantage over non-diversified firms. Nevertheless, competitors might be able to diversify their operations to get comparable advantages; in that scenario, synergy would lead to competitive parity. Porter (1985) also stated that efficiency increases can be attained by eliminating waste from reworking outputs and by adapting various resources or activities to a single objective by making them mutually supportive (Iversen, 2000).

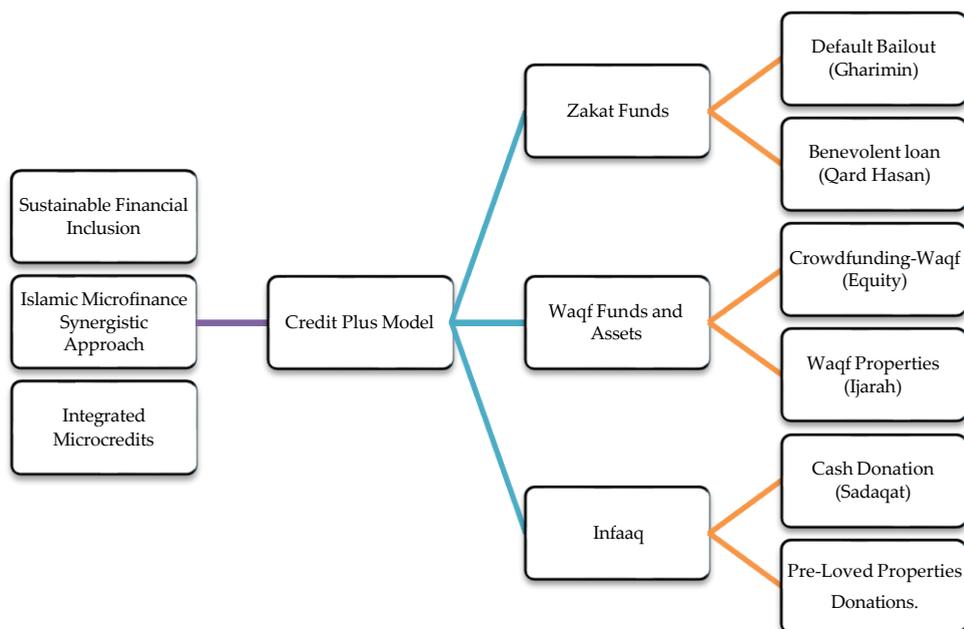
4.2.2. Synergy relationship between IMF and ISF about Igor Ansoff

Shabbir (2018) highlights that if there is synergy between the structured finance solution of Islamic social finance and existing Islamic microfinance programs, it will enhance the financing capacity of existing Islamic microfinance providers. In addition, this will also minimise the overall risks associated with operating Islamic microfinance institutions and enhance organisational innovation in the end. By utilising social finance instruments such as zakat, infaq, and waqf, Islamic microfinance institutions can offer new products in the market that are more attractive to potential customers, making it easier for them to escape the vicious cycle of poverty. Furthermore, ISF tools can help focus on creating more cohesive and convergent policies that direct these resources toward meeting the requirements of people experiencing poverty who receive Islamic microfinance.

4.3. Proposed Conceptual Framework: Islamic Credit Plus

This study developed a Credit-Plus concept based on a synergistic relationship by enhancing Islamic Microfinance capabilities through integration with various Islamic Social Finance resources. As argued in this study, Islamic social finance (ISF) instruments, such as zakat, waqf, and infaaq, can also be a regular source of funds for microfinance programmes and thus can strengthen these programmes eventually.

In the proposed framework, it is suggested that Zakat money be collected for people with low incomes as a benevolent loan (*qard-e-hasan*) or as a default bailout (to *gharimin*). The waqf fund that will be collected for distribution to people experiencing poverty will be a cash waqf, a crowdfunding waqf, or an equity waqf, as well as other waqf properties, including *ijarah*. Again, the infaaq portions will be collected as cash donations, Sadaqat, or as donations of pre-loved properties. The credit-plus model will integrate sustainable financial inclusion, a synergistic approach that combines Islamic microfinance with sustainable financial inclusion. The diagram below shows the conceptual pattern of this study:



Source: Author's own

Figure 1. Conceptual Framework

4.4. Islamic Microfinance Synergistic Approach

As explained by Islam et al. (2023), the religion of Islam encourages people to engage in social causes because it upholds the idea that individuals should be connected to their society. As a result, the Islamic social value system regards solving societal problems as both a shared and personal obligation. In this sense, the Islamic financial system introduces specific financial instruments to address social challenges and improve social well-being. To guarantee the equitable distribution of wealth, the Islamic economic system consists of a comprehensive financial framework that includes some unique financial tools, namely social funds, such as Qard Hasan (interest-free charitable loans), Sadaqah (charity), Waqf (endowments), and Zakat (mandatory almsgiving) (Kooli et al., 2022). These financial tools only improve social welfare (Yazdi et al., 2021). These tools are more beneficial when applied in socially conscious enterprises, such as Islamic microfinance institutions (Andriyani et al., 2020). Nevertheless, Islam et al. (2023) contended that they have not been institutionalised enough to support Islamic microfinance initiatives and social enterprises to date.

Haruna and Ayuba (2015) proposed a model for integrating Zakat and Waqf with microfinance institutions in Kano State, Nigeria. The researchers found that, because all of their clients are low-income and rarely save money for investments, Islamic microfinance institutions (IMFIs) worldwide struggle to maintain sufficient capital and working capital. Since credit is now their sole product, they also struggle with a lack of product variety. These are hindered by their competitiveness and the capacity to meet their clientele's diverse range of financial needs. The issues relating to a shortage of funds to operate the loan company will be reduced by combining the Waqf and Zakat with the IMFI. Thus, these institutions' competitive position can be strengthened since IMFI can offer a range of financial products.

Through a concept paper based on literature reviews, Islam et al. (2023) conclude that when used in Islamic microfinance programs and various social businesses, ISFs can lead to higher levels of social well-being than when given to charity in an unrestricted manner. This is because both business models utilise entrepreneurial means to promote social betterment while remaining technically independent and financially viable. ISFs can also enhance the investment strategy employed by social businesses, making them more receptive to charitable giving. Zakat, waqf, and infaq could be integrated to cover certain operating costs of Islamic microfinance institutions or tackle business risks. Zakat or waqf can also serve as a source of startup capital for Islamic microfinance institutions. However, the secondary data weakened the arguments presented by Islam et al. (2023).

The creation of Islamic microfinance organisations based on Zakat, Waqf, and Sadakat was suggested by Kahf (2004). They proposed using the returns from the Waqf and Sadaqat funds to finance the economy's productive sectors by offering interest-free microloans, engaging in Islamic debt and non-debt financing, and so on. These strategies can potentially foster long-term, sustainable economic growth and the advancement of the populace. Again, through literature review, Ali (2014) found that the zakah and waqf mechanisms are suitable for Islamic microfinance due to their Sharia-compliant frameworks and original Islamic ideas of helping people experiencing poverty and those in need. Zakah and Waqf are viewed as the most suitable instruments to help the impoverished who need financing, and may ultimately be successful in reducing poverty when used in conjunction with the microfinance concept.

As Dusuki (2008) noted, microfinance has garnered considerable attention as a means of developing the economies of rural communities and is essential for reducing poverty. It is intended to help underprivileged groups in society who are socially and economically marginalised and unbankable, typically because they lack assets, land, guarantors, literacy, or collateral. However, the existence of microfinance institutions offers promise for reducing poverty and the suffering of the average person. Dusuki (2008) further contended that while MFIs are not as sophisticated in raising capital as Islamic banks, other funding options still exist. Aside from conventional deposits and equity, IMFIs can also raise funds from donations, zakat, and waqf funds, as well as government grants, which can be included in Islamic microfinance institutions.

By effectively integrating with Islamic microfinance programmes, Haruna and Ayuba (2015) found through content analysis of government papers and published literature that both Waqf and Zakat can bring about economic success and peace. It says combining Zakat and Waqf through Islamic Microfinance should be considered since it offers the government a stable real economy and supplies it with everlasting, sustainable funding. By combining Waqf and Zakat, the microfinance organisation can also leverage the unique benefits that each instrument offers. Haruna and Ayuba (2015) also stated that in addition to the available equity and internal funding of the institutions, integrating Zakat and Waqf with microfinance overcomes the restrictions of fund mobilisation.

4.5. Islamic Credit Plus Model

4.5.1. Zakat funds

Establishing Islamic microfinance institutions based on zakat that gives the impoverished access to capital is necessary to end poverty. In Sudan, for instance, the proceeds from Diwan al Zakah were utilised to provide interest-free loans to a group of average farmers regularly hit by drought and a lack of fertiliser. Funding was provided to them to increase their output, increase zakah contributions, and prevent them from falling into the impoverished category, thereby preserving their self-worth. Between 2003 and 2004, it provided a total of \$336,500 in loans to 8,000 people (Ali, 2014). The average family loan was not more than \$42.1 for six months. The overall cash crop value was approximately \$5 million, or fifteen times the total loan amount. \$250.5 million, or 74.4% of the loans, was collected in Zakat from farmers (Ali, 2014). Furthermore, the farmers were completely reimbursed for the loans (Ali, 2014). According to Ismail and Possumah (2013), zakat-based IMFIs have the following features:

Table 1. Model of Zakat-Based Islamic MFIs

Zakat Based Islamic MFIs	
Usage of funds	Economic Production and Development
Sources of Funds	Zakat
Nature of Funds	Charity and Obligation
Type of charges	Interest-free
Nature of recovery	Only Community pressure
Type of Contributors	Obligatory
Type of motivation	Taqwa, Obligation, Brotherhood
Type of Empowerment	Family or Individual
Level of Participation	Compulsory participation by every individual in the society

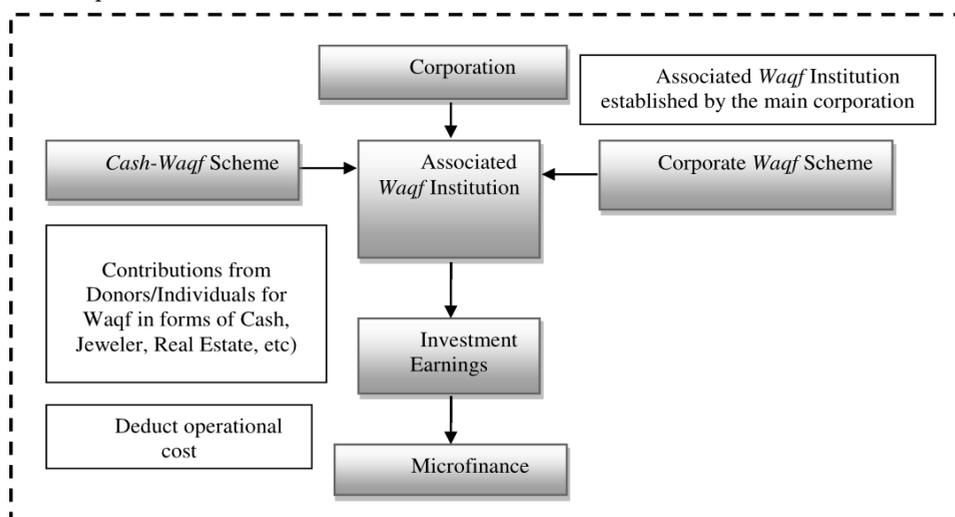
Source: Ismail & Possumah, 2013

Islamic microfinance organisations based on Zakat can collect money through Qardh Hasan, Sadaqat, and Zakat—compulsory charity and discretionary charity, respectively (interest-free deposit) (Ismail & Possumah, 2013). Implementing zakat and sadaqat will lessen the need to divert funds intended for investment into unproductive uses, increasing total returns on investment and lowering the likelihood of loan default. The main benefit of zakat-based IMFIs is that they give the underprivileged and needy the funding they need to start their enterprises and provide them with an incentive to work hard so they may repay the principal amount with no further fees. If the beneficiary cannot repay the loan, they become ghaarim, or "one burdened with debt." As a result, the beneficiary can use zakat as a legal means of repaying debt. This technique can lessen the receivers' stress related to company risk, foster a climate conducive to productive labour, and improve societal economic prospects (Ismail & Possumah, 2013).

According to Hassan et al. (2012), zakat aspires to enrich people in need instead of just providing for their basic needs. In light of this, the Zakat Institution has created initiatives to encourage Asnaf's economic activity and break the cycle of poverty. The efficiency of the Zakat fund's distribution is still in doubt because of the numerous duties that the Zakat Institution must fulfil. Zakat Institutions can help provide a more comprehensive manner of funding to the qualifying asnaf by working with other institutions, particularly microfinance institutions. The programme will identify and choose participants who can work and are interested in business. Thus, microfinance will supply the capital or business support needed for the productive asnaf. This kind of funding is intended to cover both the startup costs and the operating capital needs of the company (Hassan et al., 2012).

4.5.2 Waqf funds and assets

As highlighted by Ali (2014), the foundation of the Islamic microfinance concept based on waqf is the idea that resources are donated as waqf and should only be used appropriately to help people in need. As a result, Waqf-based Islamic MFIs have substantially lower expenses than traditional MFIs and are funded by the Waqf Endowment Fund. Furthermore, as they are donations, no returns are anticipated. While Waqf money will lower financial expenses and increase the MFIs' economic sustainability, Islamic MFIs pay returns on funds from deposits and beneficiary savings. In addition, the funding should be given to those in extreme poverty through Qardh Hasan or charitable loans, for which a return of the principal is not anticipated. The following figure depicts a waqf-based Islamic microfinance model:



Source: Ali, 2014

Figure 2. Waqf-based Islamic Microfinance Model

Saad et al. (2017) also opined that corporate waqf can be used to finance Islamic microfinance programmes. According to them, a microfinance programme or any social business could be initiated with the capital when it reaches the targeted amount, and corporate waqf can address this issue if appropriately planned, structured, and managed.

Through the content analysis method, [Abdullahi et al. \(2022\)](#) concluded that because cash waqf donors do not seek financial gain, waqf-based Islamic microfinance institutions (MFIs) can offer low-cost capital to underprivileged business owners. Additionally, waqf property revenues are recommended to exclusively fund the microfinance fund to guarantee the waqf's perpetuity. According to [Abdullahi et al. \(2022\)](#), Islamic microfinance based on cash waqf will assist microentrepreneurs in obtaining low-cost capital without needing collateral. In addition to non-monetary contributions, individuals can make monetary waqf contributions in any amount they are comfortable with. This provides a flexible way for people to give back and support causes they care about.

Similarly, [Saad and Anuar \(2009\)](#) described how potential donors who wish to contribute money to support the impoverished could be approached to provide cash waqfs for revenue-generating activities. An Islamic microfinance institution (IMFI) serving as the fund's trustee may source the funds. The impoverished or in-need micro-entrepreneurs will, after that, be the qualifying recipients of the monetary waqf, as determined by the IMFI. These micro-entrepreneurs can get loans on a cost-plus (*murābahah*) or profit-sharing (*muḍārabah*) basis. This way, when the micro-entrepreneurs pay back their loans, the proceeds can be reinvested in the cash waqf pool, which then serves as a source of funding for further micro-entrepreneurs. The *qard al-ḥasan* principle can be used to provide loans to the impoverished to help them meet their most basic needs while they live in extreme poverty. This type of loan is offered to the underprivileged for a predetermined amount of time without requiring them to pay back any profit or interest. Only the initial loan amount must be returned by the *Qard al-ḥasan* borrower.

4.5.3 Infaq

One type of *sadaqah* that can be monetary or non-monetary (in the form of wealth or property) is *infaq* ([Aji et al., 2020](#)), which can also serve as an effective source for microfinance programmes. *Fiqh* describes *infaq* as granting a portion of one's property to those to whom it is religiously prescribed to give it, including the impoverished, kin, orphans, and others ([Ulya & Al Azizah, 2021](#)). In particular, all Muslims are encouraged to give to charity, or *infaq*, through which Islam becomes one of the world's most generous religions ([Aji et al., 2020](#)). As the Prophet (PBUH) said, "Whoever relieves a believer from one of the troubles of this world, Allah will relieve him of one of the difficulties on the Day of Resurrection. Whoever relieves someone's suffering, Allah will ease his suffering in this world and hereafter" (*Sahih Muslim*).

5. Results and Recommendations

This research presents an innovative ISF-based Islamic microfinance Credit-plus model that emphasises collaboration between Islamic microfinance institutions and Islamic social finance organisations overseeing *Zakat*, *Waqf*, and related activities. When effectively executed, this pioneering system could help overcome resource limitations faced by IMFBS and improve transparency throughout. Over time, it has the potential to substantially bolster Nigeria's Islamic microfinance sector overall. Additionally, the ISF-based framework discussed here could have promising applications not only in Nigeria but also in other countries, given that Islamic finance is rooted in risk-sharing principles. To truly enhance the economic well-being of impoverished and vulnerable groups, it is necessary to transition from the current conventional microfinance approach to a more effective and sustainable Islamic microfinance system.

Besides funding deficits, this research shows that their narrow product range limits the long-term viability of Islamic MFIs. There are significantly fewer institutions working with *awqaf*, *zakah*, and *qard al-ḥasan* than anticipated, and most of those that do exist do not collaborate with other Islamic microfinance organisations to broaden their impact. The study suggests a Credit-Plus model that fosters partnerships to strengthen Islamic microfinance by combining it with other Islamic social finance mechanisms.

This study highlights that *zakat*, *waqf*, and *infaq* are key Islamic social finance (ISF) tools capable of providing dependable funds to expand microfinance initiatives. The proposed system involves collecting *zakat* and *waqf* funds for charitable loans (*qard-e-ḥasan*) or bailouts for defaulters (to *gharimin*), supporting the poor. These funds will be allocated to cash *waqf*, crowdfunding *waqf*, or equity for those in need. Additionally, *infaq* funds will be gathered through *sadaqat*, cash donations, or contributions of previously owned property. The credit-plus approach combines Islamic microfinance's synergistic methods with sustainable financial inclusion. To meet the funding requirements of Islamic microfinance institutions (MFIs), *zakat*, *waqf*, and *infaq* will be unified into a single framework. This integration aims to give marginalised community members access to investment opportunities, encouraging participation in activities that foster economic growth and alleviate

poverty.

This study will make a significant contribution by paving a new academic avenue for the study of financial inclusion in Nigeria, specifically the Islamic poverty alleviation scheme. Furthermore, this research empirically contributes to academia by examining the synergistic relationships between Islamic financial institutions, such as Islamic social finance and Islamic microfinance, the inclusivity of their products and services, and how they may leverage resources to alleviate poverty sustainably. In addition, this study will provide existing Islamic microfinance institutions and Islamic Social Finance organisations with a practical alternative for addressing their internal difficulties and maximising their financial and social impact with limited resources.

The results of this research will contribute to the efforts of both governmental and private sectors in fighting poverty by channelling more funding, such as Zakat funds and Cash Waqf to the needy microentrepreneurs with the credit-plus package, strengthening Islamic MFI through collaboration with zakat and waqf institutions, to fulfil their social mission to help people experiencing poverty and reduce financial exclusion. Furthermore, with the significant demand for Islamic MFIs in a poverty-ridden country like Nigeria as an alternative to the traditional MFI, there are incentives for conventional MFIs to convert to Islamic MFIs in the future.

Additionally, the findings of this study are likely to be of interest to policymakers, professionals, boards of directors, the public, clients, and academics, particularly in the context of philanthropreneurs and Islamic microfinance. Policymakers such as the Central Bank of Nigeria, the Ministry of Cooperatives and SMEs and the Association of Zakat and Waqf Operators in Nigeria (AZAWON) may use the findings regarding the formulation of new regulations to support zakat and waqf-based Islamic MFIs, capacity building, public education, awareness and give other incentives to establish, strengthen and empower Islamic MFIs in Nigeria.

6. Conclusion

To address poverty in Nigeria, Islamic microfinance banks and institutions offer a promising solution. However, their growth faces several challenges, including issues with fundraising, fintech, and awareness, among other factors. This study proposes a new ISF-based Islamic microfinance Credit-plus model that emphasises strong collaboration between Islamic microfinance institutions and Islamic social finance organisations managing Zakat, Waqf, and related activities. When effectively implemented, this innovative approach can help overcome the resource limitations of IMFBS and enhance transparency throughout the entire process.

With Islamic social finance tools such as zakat, waqf, and sadaqah, this research proposes a revolutionary, synergistic plan that enables the current Islamic microfinance system to expand its financial outreach in Nigeria by implementing the innovative Credit-Plus model. The product comprises an all-inclusive Shariah-compliant solution that incorporates several Islamic Microfinance and Islamic Social Finance offerings. The results of this research will contribute to the efforts of both governmental and private sectors in fighting poverty by channelling more funding, such as Zakat funds and Cash Waqf, to the needy microentrepreneurs with the credit-plus package, strengthening Islamic MFI through collaboration with zakat and waqf institutions, to fulfil their social mission to help people experiencing poverty and reduce financial exclusion. Furthermore, with the significant demand for Islamic MFIs in a poverty-ridden country like Nigeria as an alternative to the traditional MFI, there are incentives for conventional MFIs to convert to Islamic MFIs in the future.

This study also indicates that Islamic microfinance organisations should enhance their efforts to empower microfinance clients in achieving economic independence. Once again, it recommends that more ISF and IMF institutions start collaborating to address resource shortages. Additionally, Islamic MFIs should secure funds through Islamic social finance instruments from NGOs, wealthy Muslims, and individuals who are highly motivated to take part in volunteer and humanitarian initiatives.

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Integrating Financial Decision-Making into Islamic Financial Literacy as A Mediating Factor: Implications for Enhancing Financial Well-Being

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Abstract

Financial decision-making is a crucial process that directly influences the financial well-being of individuals, households, businesses, and governments. Despite its importance, a substantial number of individuals lack the essential financial knowledge and skills needed for effective financial management. This study aims to investigate the mediating role of financial decision-making in the relationship between Islamic financial literacy and financial well-being among Malaysian households. This study is original in its pioneering exploration of the unique role that financial decision-making plays within the framework of Islamic financial literacy, and its significant contribution to enhancing the financial well-being of Malaysian households. The study employs quantitative methods, with data collected from 402 respondents in the Klang Valley region using a cross-sectional design and questionnaire methodology. The collected data was analyzed using Structural Equation Modeling (SEM) techniques, specifically PLS-SEM 4.0 software and SPSS 26. The findings confirmed that financial decision-making effectively mediates the relationship between Islamic financial literacy and financial well-being. By illustrating how Islamic financial literacy shapes decision-making behaviors, the study provides valuable insights into how informed financial choices can significantly enhance the financial stability and well-being of Malaysian households. The findings suggest that policymakers and stakeholders in the financial industry should design targeted financial literacy and awareness programs that encourage greater engagement with Islamic financial products and services.

Keywords: Islamic financial literacy, financial well-being, financial decision-making, households, Islamic banking and finance

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1. Introduction

The increase in Islamic financial literacy is playing a pivotal role in the shift towards Islamic banking in Malaysia. As more consumers understand the principles behind *riba*-free transactions and risk-sharing, they are becoming increasingly attracted to Islamic financial products. This shift is not solely due to the availability of Shariah-compliant products but is also driven by a deeper understanding of their ethical alignment with Islamic teachings. The "Islamic First" initiative, a strategic approach to promoting Shariah-compliant products, further accelerates this transition by positioning these offerings as the preferred choice for Muslim consumers.

Existing studies on financial well-being in Malaysia have primarily focused on broader financial literacy, often overlooking the distinction between conventional and Islamic financial principles. This gap highlights the need for further exploration into how individuals' understanding of Shariah-compliant financial products such as Islamic banking, *Takaful* (Islamic insurance), and Islamic investment products shapes their financial decision-making processes and overall financial well-being. Specifically, the relationship between Islamic financial literacy and financial decision-making, and its mediation of financial well-being, remains underexplored.

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While financial well-being has been extensively researched, most studies have approached it from a purely economic or traditional financial literacy perspective, particularly in the context of Malaysian households. However, these studies often overlook the socio-cultural and religious dimensions of financial decision-making, which are crucial in Malaysia's unique socio-cultural environment. In this context, Islamic principles play a significant role in shaping personal finance decisions. Therefore, it is essential to explore how Islamic financial literacy impacts financial decision-making in Malaysia. Additionally, while factors such as financial security, the ability to manage financial stress, and satisfaction with one's financial future are important elements of financial well-being, their relationship with Islamic financial literacy remains underexplored and requires further investigation.

This study is also relevant in supporting the MADANI national development initiative, which seeks to create a financial system that is fair, just, and aligned with Maqasid Shariah. Furthermore, this strengthens Malaysia's position as a leader in the global Islamic economy, aiming to unlock economic potential and promote sustainable social well-being. The focus is on reducing income and wealth disparities across different social classes while improving the standard of living and well-being of the Malaysian people. In this context, the study addresses the welfare of all segments of society, particularly the economically vulnerable groups, such as the B40. The outcomes of this research are expected to provide valuable insights into one of the key indicators for improving the Malaysian Well-being Index, as outlined in the 12th Malaysian Plan. This aligns with the nation's goal to build a future based on sound macroeconomic policies, ensuring that no Malaysian is left behind.

The findings of this study will also provide valuable insights into the role of Islamic financial literacy in enhancing the financial decision-making processes of Malaysian households. This is particularly important in the context of Malaysia's evolving financial landscape, where the demand for Shariah-compliant financial products is growing, and there is an increasing need for informed financial decision-making.

Furthermore, this study will fill a significant gap in the existing literature by focusing on Islamic financial literacy, a crucial but often underexplored aspect of financial education. While much research has been conducted on general financial literacy, limited attention has been given to the specific financial needs and behaviors of the Muslim population, especially in relation to Islamic finance. By addressing this gap, this study will contribute to the development of a tailored framework for Islamic financial literacy that can better equip Malaysian households to make sound financial decisions in line with Islamic principles.

The outcomes of this research are expected to provide valuable insights for practitioners, policymakers, financial institutions, and educational bodies in developing more effective financial literacy programs, particularly for the Muslim community. These programs will aim to enhance financial well-being and support individuals in achieving their life goals, in line with the concept of *al-Falah* (success and prosperity). The findings of the study will contribute to the formulation of strategies that improve financial decision-making, promote Islamic financial literacy, and ultimately enhance the financial well-being of Malaysian households. In doing so, the study will support broader socioeconomic development goals, including poverty reduction and the improvement of living standards in Malaysia.

Existing studies on financial well-being in Malaysia have primarily focused on broader financial literacy, often overlooking the distinction between conventional and Islamic financial principles. This gap highlights the need for further exploration into how individuals' understanding of Sharia-compliant financial products such as Islamic banking, Takaful (Islamic insurance), and Islamic investment products shapes their financial decision-making processes and overall financial well-being. Specifically, the relationship between Islamic financial literacy and financial decision-making, as well as how this relationship mediates the attainment of financial well-being, remains underexplored.

2. Literature Review

Several prior studies have examined financial decision-making as a mediating variable in various contexts. For example, [Sajid et al. \(2024\)](#) found that financial decision-making significantly mediates the relationship between financial literacy and household financial outcomes. Similarly, [Setyani et al. \(2022\)](#) explored decision-making in budgeting as a mediator between accounting information systems and organizational structure, particularly in relation to the performance of government agencies. In another study, [Parvathy et al. \(2022\)](#) investigated the mediating role of decision-making ability between financial capability and financial well-being, focusing on 1,000 women from community-based organizations in Kerala, India. Additionally, [Bai \(2023\)](#) examined investment decision-making as a mediating variable in the relationship between cognitive factors and financial well-being among Chinese university students.

Meanwhile, the relationship between financial decision-making and financial well-being has been a central focus in literature. Researchers have explored how various factors, such as financial knowledge, attitudes, and behaviors, influence an individual's perceived financial well-being and overall quality of life. Financial decision-making is widely recognized as a key determinant of financial well-being, impacting outcomes on both individual and societal levels. A pivotal study by [Netemeyer et al. \(2017\)](#) conceptualized perceived financial well-being as a multidimensional construct, consisting of two interrelated but distinct dimensions: the stress associated with managing current financial obligations and a sense of security regarding one's financial future. This framework suggests that financial decision-making plays a crucial role in shaping both an individual's present financial stress and their long-term financial security.

Identifying the factors that influence financial decision-making is also crucial for enhancing financial well-being, particularly in the context of adopting Islamic banking products and services. In Malaysia, the substantial growth of Islamic financial institutions reflects the rising consumer demand for Shariah-compliant financial products. This demand is driven by an increasing number of individuals who are becoming more aware of the benefits of Islamic finance and the importance of aligning their financial practices with Islamic principles.

Financial decision-making (FDM) is crucial for maintaining financial well-being and avoiding financial errors ([Sunderaraman et al., 2022](#)). At the household level, FDM is a multifaceted process, influenced by a range of factors such as financial literacy, cognitive abilities, and family dynamics. For example, studies by [Hilgert et al. \(2003\)](#) and [Lusardi \(2012\)](#) have highlighted the importance of financial literacy and numeracy as key indicators of decision-making competence, which are positively correlated with improved financial well-being. Moreover, the nature of financial decisions varies, encompassing smaller, everyday purchases, bill payments, savings, investing, and long-term financial planning.

Most studies on financial decision-making have predominantly focused on Western contexts, with limited research addressing Asian settings ([Nguyen et al., 2018](#)). In particular, cultural factors, especially family influence, play a crucial role in shaping financial decisions within Asian societies. For example, [Xia et al. \(2016\)](#) highlighted that decision-making dynamics differ significantly across cultures, with joint decision-making being more prevalent in family-oriented societies. In line with this, research from Singapore has demonstrated that family egalitarianism is positively correlated with shared financial decision-making.

Furthermore, [Nguyen et al. \(2018\)](#) emphasized the significant role of parents in influencing their adult children's financial decisions, particularly in Asian cultures, where extended family involvement is more prevalent than in Western societies. In these cultural contexts, financial decision-making often becomes a collective process, involving not only parents and spouses but also children. Similarly, [Zaimah \(2019\)](#) observed that a husband's role in financial decision-making has a substantial impact on the financial well-being of dual-income families, where the husband's higher income contribution compared to the wife is a key influencing factor.

However, existing financial literacy models, particularly those focusing on household decision-making, may not fully capture the complexities introduced by cultural and family structures. In this regard, [Hohn \(2020\)](#) found that financial decision-making also varies by gender, with men more frequently assuming responsibility for financial decisions, while women tend to make decisions that align with traditional roles. Additionally, Hohn's study suggests that age and experience are positively correlated with financial decision-making, as older individuals are more likely to make informed choices based on their accumulated experience.

As financial technology continues to evolve, especially in rural areas, the relationship between financial decision-making and financial well-being is experiencing significant changes. However, existing literature often overlooks a comprehensive integration of Islamic financial literacy into this evolving discourse. While there is a growing body of research on financial decision-making, a notable gap persists in studies that explore how financial decision-making acts as a mediating variable between financial literacy and financial well-being, particularly within the context of Islamic finance. This gap underscores the necessity for further investigation into how Islamic financial literacy influences financial decision-making and its subsequent effect on financial well-being.

Several prior studies have examined financial decision-making as a mediating variable in various contexts. For example, [Sajid et al. \(2024\)](#) found that financial decision-making significantly mediates the relationship between financial literacy and household financial outcomes. Similarly, [Setyani et al. \(2022\)](#) explored decision-making in budgeting as a mediator between accounting information systems and organizational structure, particularly in relation to the performance of government agencies. In another study, [Parvathy et al. \(2022\)](#) investigated the mediating role of decision-making ability between financial capability and financial well-being,

focusing on 1,000 women from community-based organizations in Kerala, India. Additionally, Bai (2023) examined investment decision-making as a mediating variable in the relationship between cognitive factors and financial well-being among Chinese university students.

Further supporting these findings, Mahapatra et al. (2018) highlighted the crucial mediating role of financial decision-making in the link between financial cognition and personal financial planning. These studies collectively emphasize the importance of improving financial decision-making skills and fostering positive financial attitudes, as they can significantly impact individuals' overall financial well-being and life satisfaction (Netemeyer et al., 2017; Morgan & Long, 2019).

3. Conceptual Framework

This paper will apply a quantitative approach, primarily utilizing a survey questionnaire for data collection. This study aims to address the existing gap in literature by examining how financial decision-making mediates the relationship between Islamic financial literacy and financial well-being, with a particular focus on the integration of Islamic principles.

To specifically address the second research question and objective regarding whether financial decision-making acts as a mediator between Islamic financial literacy and the financial well-being of Malaysian households, the following hypotheses have been formulated:

- H1: Islamic financial literacy has a positive significant relationship with financial well-being*
- H2: Islamic financial literacy has a positive significant relationship with financial decision-making*
- H3: Financial decision-making has a positive significant relationship with financial well-being*
- H4: Financial decision-making mediates the relationship between Islamic financial literacy and financial well-being*

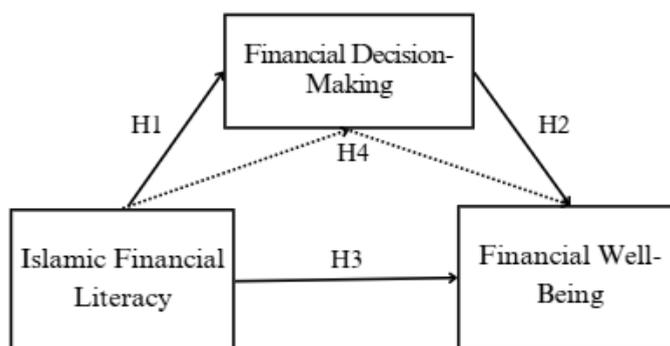


Figure 1: Conceptual Framework

4. Research Methodology

This study focused on Malaysian citizens residing and employed within the Klang Valley area. Due to its high population density, as reported by the Department of Statistics Malaysia (2022), Klang Valley was deemed the most suitable location for participant recruitment. Given the characteristics of the targeted sample, employing a probability sampling method proved impractical. Research suggests that carefully implementing non-probability sampling methods, such as purposive sampling, can yield representative samples. As Sarstedt et al. (2021) outline, purposive sampling involves selecting participants based on predetermined criteria. In this study, purposive sampling was used to distribute questionnaires, with employment status and income group serving as the two key selection criteria. A total of 403 questionnaires were collected from respondents who were employed and residing in the Klang Valley area during the survey period. However, due to missing data, 40

responses were excluded, resulting in a final sample size of 363 usable questionnaires.

4.1 Variables and Measures

This study adheres to the established guidelines for index development outlined in the OECD Handbook on Constructing Composite Indicators 2008. The process involves selecting relevant indicators, standardizing their measurements, assigning appropriate weights, and subsequently combining them. In line with the recommendations of [Hair and Brunsveld \(2019\)](#), two measurement scales are utilized in this study: interval and nominal. Interval scales are applied to both dependent and independent variables because each unit on the scale represents the same degree of the characteristic being measured across the entire range. The measurement items for the interval scale are adapted specifically to the context of Islamic financial literacy and financial well-being.

The initial draft of the questionnaire prioritized content validity and clarity. A Likert scale format, commonly used in quantitative research ([Xie & DeVellis, 1992](#)), was employed to develop the survey questions. This format presents statements followed by response options reflecting varying degrees of agreement or endorsement, using a five-point scale ranging from 1 ("strongly disagree") to 5 ("strongly agree"). Following the selection of measurement scales, a structured questionnaire was designed. To ensure the clarity, flow, and meaning of the items, the questionnaire was pre-tested with four academic experts and 30 participants. Minor concerns raised during the pre-testing were addressed, resulting in revisions to the wording of certain statements. Given Malaysia's multicultural society, which includes Malay, Chinese, and Indian populations, the questionnaire was prepared in both English and Bahasa Malaysia. This bilingual approach accommodates respondents' language preferences and facilitates cross-checking the meaning of statements when needed.

4.2 Estimation Method

This study selected Partial Least Squares Structural Equation Modeling (PLS-SEM) over Covariance-Based SEM (CB-SEM) due to its advantages in exploratory research, target prediction, and its ability to handle non-normal data and small sample sizes characteristics often encountered in the early stages of research. Given that this study aims to predict and explain financial well-being and Islamic financial literacy, PLS-SEM is particularly well-suited for these objectives. Furthermore, PLS-SEM offers superior statistical power, regardless of sample size or data distribution ([Hair et al., 2017](#)). The analysis was conducted using SmartPLS 4.0 for model evaluation, while SPSS 27 was used to perform descriptive analysis and F-tests. Following the two-step procedure recommended by [Hair et al. \(2017\)](#), the first step involved assessing the measurement model based on composite reliability, convergent validity, and discriminant validity. After confirming that the measurement model met the required benchmark values, the second step involved evaluating the structural model to test the hypotheses and assess prediction accuracy.

5. Results and Discussions

5.1 Descriptive Analysis of the Respondent

Table 1 presents the sample demographics, which were slightly skewed towards females (53.4%). The majority of respondents (66.7%) were between 25 and 40 years. Educationally, most respondents held a Bachelor's degree (73%), followed by Master's degrees (15.2%). In terms of employment, 66.7% worked in the private sector, while 18.2% were employed in the government sector, 5.2% were self-employed, and 6.6% were students. Marital status was predominantly single (51.5%) and married (47.7%). While the national population distribution of Malaysia varies, the Klang Valley sample was predominantly Bumiputera (Malay) at 93.4%, reflecting the region's demographics. Most respondents (66.1%) had fewer than three financial dependents. In terms of income, 47.4% of respondents fell within the B40 group (below RM4,850), 39.4% were in the M40 group (RM4,851 – RM10,970), and 13.2% were in the T20 group (above RM10,970). The average household income in the sample (RM5,000) was slightly higher than the Department of Statistics Malaysia's reported average for Selangor and Kuala Lumpur (RM3,840-RM4,013) in 2021.

Regarding savings behavior, over half of the respondents (55.9%) saved between 1% and up to 10% of their monthly income, while 28.7% saved between more than 10% and 20%. Approximately 9.4% saved more than 20%, and 6.1% did not save at all. Notably, 7.4% of respondents considered their income insufficient, 54.8% reported it was only enough for basic needs, 22.3% found it sufficient for most things, and 15.4% felt it was adequate for all desired expenses, with savings remaining.

Table 1. Respondents' Profile

Variables	n	%
<i>Gender</i>		
Male	169	46.6
Female	194	53.4
Total	363	100
<i>Age</i>		
Below 25	53	14.6
25-40 years old	242	66.7
41-50 years old	36	9.9
51 and above	32	8.8
Total	363	100
<i>Education Background</i>		
SPM/ Certificate	17	4.7
Diploma	19	5.2
Bachelor's/Professional Degree	265	73.0
Master	55	15.2
Phd	7	1.9
Total	363	100
<i>Employment Status</i>		
Self-Employed	19	5.2
Private	266	73.3
Government	71	19.6
Retiree	7	1.9
Total	363	100
<i>Marital Status</i>		
Single	187	51.5
Married	172	47.4
Divorced/Widowed	4	1.1
Total	363	100
<i>Number of Financial Dependents</i>		
Less than 3 People	240	66.1
3-5 People	107	29.5
More Than 5 People	16	4.4
Total	363	100
<i>Race</i>		
Bumiputera	339	93.4
Chinese	12	3.3
Indian	12	3.3
Total	363	100
<i>Monthly Household Income (Group)</i>		
B40 (Less than RM 4,850)	172	47.4
M40 (RM4,851-RM 10,970)	143	39.4
T20 (Above RM10,970)	48	13.2
Total	363	100

Monthly Savings		
0%	22	6.1
1-10%	203	62.0
10-20%	104	28.7
>20%	34	9.4
Total	363	100
Current Income Adequacy		
Not Enough	27	7.4
Enough for Basic Needs	199	54.8
Enough for Most Things	81	22.3
Enough to Buy All the Things Wished for and Could Save Money	56	15.4
Total	363	100

Source: Author (2024)

5.2 Measurement Model Analysis

The theoretical model of this study consists of a total of three latent variables: Islamic financial literacy (IFL), financial decision-making (FDM) and financial well-being (FWB). The quality of the measurement model was assessed using internal consistency and convergent validity tests, factor loading assessment, and collinearity diagnostics. The average VIFs of all constructs were less than five (Hair et al., 2022), indicating that multicollinearity is not likely to be a problem in the subsequent data analysis, as shown in Table 2.

Following the PLS-SEM method, constructs' reliability and convergent validity were evaluated using composite reliability (CR), factor loading, and average variance extracted (AVE) (Hair et al., 2017). Using SmartPLS 4.0, the model was analyzed following the standard algorithm criteria (Hair et al., 2017). The initial assessment of construct reliability was achieved for FDM and FWB but not for IFL. Of the ten items, IFL, IFL1, IFL3, IFL5, IFL6 and IFL7 exhibited poor factor loadings, which also resulted in a very low AVE of 0.390. The deletion of these five indicators increased the value of AVE (see Table 3).

The theoretical model is re-evaluated using SmartPLS4 to assess the properties of the measurement scale. According to the standard criteria, composite reliability (CR) should be higher than 0.70, factor loading should exceed 0.70, and AVE should be above 0.50 to ensure the reliability and convergent validity of the measurement model, as shown in Table 3 below. Consequently, based on the Composite Reliability (CR) and Cronbach's Alpha coefficients, the convergent validity of the constructs is considered appropriate. The HTMT ratio analysis, shown in Table 4 below, was used to assess discriminant validity, and all the values were below the cutoff level of 0.85 (Henseler et al., 2015).

Table 2 Collinearity Results

Model Variables	Collinearity Statistics VIF
Islamic Financial Literacy	1.938
Financial Decision Making	2.782
Financial Well-Being	

Table 3 Reliability and Convergent Validity of the Measurement Model

Construct	Items	Loadings	CA	CR	AVE
Islamic Financial Literacy	IFL 2	0.763	0.756	0.834	0.501
	IFL4	0.694			
	IFL8	0.661			
	IFL9	0.783			
	IFL10	0.736			
	FDM1	0.767	0.869	0.899	0.562

Financial Decision Making	FDM2	0.790	0.861	0.893	0.545
	FDM3	0.768			
	FDM4	0.722			
	FDM5	0.755			
	FDM6	0.787			
	FDM7	0.647			
Financial Well-Being	FWB1	0.742			
	FWB2	0.775			
	FWB3	0.789			
	FWB5	0.750			
	FWB6	0.693			
	FWB7	0.713			
	FWB9	0.698			

*CA= Cronbach's Alpha; CR= Composite Reliability; AVE= Average Variance Extracted

Table 4. HTMT discriminant validity results

	Islamic Financial Literacy	Financial Decision Making	Financial Well-Being
Islamic Financial Literacy		0.594	0.342
Financial Decision Making	0.594		0.322
Financial Well-Being	0.342	0.322	

The direct effects of Islamic financial literacy and financial decision-making on financial well-being are presented in Table 5, while mediating effect of financial decision-making is shown in Table 6.

Table 5. Path coefficients for

Research Hypotheses	Relationship	Path Coefficient	Std. deviation	t-value	p-value	Results
H1	IFL → FDM	0.790	0.039	20.113	0.000	Supported
H2	FDM → FWB	0.385	0.159	2.419	0.000	Supported
H2	IFL → FWB	0.553	0.068	12.288	0.000	Supported

IFL- Islamic financial literacy, FWB- Financial Well-Being, FWB- Financial Well-Being
Significance at **p<0.01 level

Table 6. The mediation effect of FDM on the relationship between IFL and FWB

Research Hypothesis	Hypothesis	Indirect Effect	Standard Deviation	t-statistics	p-value	Bootstrapping Mediation Result
H4	IFL → FDM → FWB	0.380	0.087	4.343	0.000	Partial Mediation

IFL- Islamic financial literacy, FWB- Financial Well-Being, FWB- Financial Well-Being

H1: There is significant relationship between Islamic financial literacy and financial decision-making among Malaysian households in Klang Valley area.

According to the path coefficients, the positive relationship between the Islamic financial literacy and financial decision-making is statistically significant (H1: $\beta = 0.790$, $p=0.000$), supporting H1. These findings indicate that individuals with higher levels of IFL are more likely to make informed financial decisions in line with

Islamic principles. This result emphasizes the critical role that Islamic financial literacy plays in guiding financial decisions within Muslim communities.

These findings are consistent with previous research by Mufidah et al. (2022), who also highlighted the significance of IFL in empowering Muslims to make decisions that align with Islamic Sharia. Furthermore, Sajid et al. (2024) demonstrated that financial decision-making mediates the relationship between financial literacy and household financial outcomes, reinforcing the idea that improved financial literacy can lead to better financial decision-making and, ultimately, improved financial outcomes for households.

The findings of H1 confirmed a significant positive relationship between Islamic Financial Literacy (IFL) and financial decision-making, indicating that individuals with higher IFL levels are more likely to make informed financial choices aligned with Islamic principles.

H2: There is significant relationship between financial decision-making and financial well-being among Malaysian households in Klang Valley.

The relationship between financial decision-making and financial well-being was significant at the 0.01 level (H2: $\beta = 0.358$, $p=0.000$), supporting H2 and indicating its key role in influencing financial well-being. Furthermore, the current results align with previous research by Martinez and Andal (2022), which has consistently shown a positive relationship between financial decision-making and financial well-being.

Recent research by Martinez and Andal (2022) also demonstrated that financial decision-making skills are essential for achieving financial well-being among public school teachers in the Philippines. Similarly, Osman et al. (2019) found that individuals who are capable of analysing and utilizing financial information are more likely to make sound financial decisions, thereby enhancing their financial well-being.

The result for this hypothesis is consistent with previous research by Sinha et al. (2024), which suggests that households making prudent financial decisions, including managing debts effectively, saving regularly, and planning for retirement, report significantly higher levels of financial well-being. Additionally, Zaimah (2019) also identified a significant relationship between financial product decisions and financial well-being. The findings from this study highlight the crucial role of sound financial decision-making in achieving improved financial outcomes.

H3: There is significant relationship between Islamic financial literacy and financial well-being among the Malaysian households in Klang Valley area.

As shown in Table 5, the results confirm a significant positive relationship between Islamic financial literacy and financial well-being among Malaysian households (H3: $\beta = 0.553$, $p=0.000$), suggesting that higher levels of Islamic financial literacy are associated with greater financial well-being. Specifically, individuals with stronger Islamic financial literacy tend to exhibit superior money management skills and engage in more effective financial planning.

These findings align with previous research by Respati et al. (2023) and Urkash et al. (2020), who also found a positive link between financial literacy, particularly Islamic financial literacy, and financial well-being. Similar to our results, their studies emphasized that individuals with greater financial knowledge are better equipped to make informed financial decisions, leading to improved financial outcomes. Hypothesis 3 was supported, demonstrating a significant positive association between Islamic financial literacy and financial well-being, suggesting that enhanced Islamic financial literacy contributes to improved financial outcomes and overall financial well-being.

H4: Financial decision-making mediates the relationship between the role of Islamic financial literacy and financial well-being among the Malaysian households in Klang Valley.

To test the mediation effect of financial decision-making on the relationship between Islamic financial literacy and financial well-being, the bootstrapping method was used using PLS-SEM. The findings are presented in Table 6. The benchmark for assessing the mediating effect is as follows: 0.25 for a large effect, 0.09 for a medium effect, and 0.01 for a small effect. In this study, Hypothesis 4 (H4) was supported and thus accepted. As shown in Table 6, the p-value for the mediation effect was significant ($p\text{-value} < 0.01$), with the indirect effect size reaching 0.380. This indicates that financial decision-making strengthens the effect of

Islamic financial literacy on financial well-being.

Consequently, financial decision-making serves as a partial mediator, strengthening the relationship between Islamic financial literacy and financial well-being. These results align with previous studies, which have demonstrated that financial decision-making significantly mediates the relationship between financial literacy and household financial outcomes (Sajid et al., 2024). These findings suggest that improved financial decision-making can positively influence individuals' decisions to subscribe to Islamic financial products and services, ultimately contributing to better financial well-being.

6. Conclusion and Recommendations

This study examined the relationship among Islamic financial literacy, financial decision-making and financial well-being among the Malaysian households in Klang Valley area. The study confirmed a positive relationship between Islamic financial literacy and financial well-being, highlighting the importance of financial decision-making in bridging information gaps and promoting better financial practices.

As hypothesized, financial decision-making mediated the relationship between Islamic financial literacy and financial well-being. The findings are discussed in relation to their implications for financial planners, financial institutions, industry players, policymakers, and government agencies. The study underscores the importance of understanding how Islamic financial literacy and its related factors influence financial well-being, offering valuable insights for practitioners in designing targeted programs, campaigns, products, and services to improve financial planning and decision-making skills among Malaysians.

As with any research, this study acknowledges several limitations and offers suggestions for future work. Future research could further investigate the role of Islamic financial literacy and its impact on financial decision-making, particularly in enhancing financial well-being. This could assist practitioners in designing initiatives that help Malaysians make more informed financial decisions. Additionally, the findings are significant for the Malaysian government, as they highlight the current state of Islamic financial literacy among the population and emphasize the need for educational initiatives focused on Shariah-compliant financial concepts. By promoting greater financial literacy, policymakers and relevant stakeholders can empower individuals to make better financial decisions, ultimately improving their financial well-being.

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Micro-Takaful Coverage Among Low-Income Communities in Malaysia: Exploring the Challenges and Proposed Solutions

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Abstract

Low-income communities in Malaysia continue to be the most vulnerable to health and income risks due to their lack of insurance or takaful coverage. To address the needs of these groups, micro-takaful plays a vital role in advancing financial inclusion by improving access to health and income protection. However, according to a report issued by BNM, takaful market penetration among low-income earners remains limited. Therefore, this study seeks to examine the key challenges contributing to this issue. This study employs comprehensive literature review examinations encompassing books, journals, case studies and policies. Additionally, it includes the field study based on the interviews conducted with the experts in the field. The study finds that Malaysia's takaful sector faces significant challenges, including demographic trends, economic barriers, and limited engagement with other institutions. To address these challenges, a strategic initiative has been developed to prioritise the inclusion of low-income communities in Malaysia within takaful coverage, supporting their health and income sustainability.

Keywords: Micro-takaful, Maqasid al-Shari'ah, financial, awareness, communities.

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1. Introduction

A report released by the Department of Statistics Malaysia (DOSM) in 2021, average household income has declined due to the pandemic, with many households from higher-income groups shifting to lower-income groups due to this decline. It is estimated that an additional 12.5 per cent of households with income less than RM2,500 would then exist in 2020. Meanwhile, 20 per cent of households from the M40 group with an income between RM 4850 and RM 10959 have moved to the B40 group. Because the percentage decrease in income for B40 and M40 households was more significant resulting in the decline of income distribution for B40 to 15.9%. According to Rapi et al., (2022), this resulted in an increasing trend in Malaysia's B40 group of people. The same risks, for example, death, illness or injury, property loss, and natural disaster, as the poor face the non-poor; however, the non-poor have access to formal insurance schemes and thus have a lower financial impact.

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From Shari'ah point of view, this circumstance has clearly caused difficulties to the people, especially in managing their life and wealth. Preserving both life and wealth are the principles of Maqasid al-Shari'ah. Rapi et al., (2022) regarded that considering the significant impact of the COVID-19 pandemic on the B40 group in Malaysia and the vulnerability of the B40 group to various risks, the need for financial products to support the B40 group is essential.

In Malaysia, takaful operators never failed to enhance the priority of Shari'ah compliant insurance schemes. As takaful is an alternative for Muslims to have their life and wealth protections, they can subscribe to the plans they afford to commit. However, despite adhering to Shari'ah compliance, the subscription of takaful plans seemingly not accessible to everyone. Hence, adhering Shari'ah alone in this matter has been arguably considered not achieving the goals of Shari'ah.

In this sense, takaful operators in Malaysia have been involved in designing another scheme, considering those who are less fortunate. According to Rapi et al. (2022), micro-takaful is another alternative of micro-insurance, where it is a type of insurance developed to protect those generally excluded from public and private insurance schemes. Micro-takaful has been introduced as a scheme that provides affordable protection at a fair amount of contribution to meet the needs of low-income groups in the protection of lives and properties. The Central Bank of Malaysia established a regulatory structure with industry participation to promote the growth of micro-takaful (Mohd Fauzi & Laldin, 2021). Based on their observation, Rom & Rahman (2012) asserted that micro-takaful is one of the mechanisms to fulfil the needs of the lower income, with the concept of providing affordable protection to the poor.

Shari'ah is a revealed prescription that acknowledges humanity to all mankind. Preserving life and wealth seemed not achievable as some people could not afford to sustain the subscription of takaful due to its price range. As such, the principles of Maqasid al-Shari'ah could not be realized as a whole when there was no protection for those who are less fortunate. In this regard, this study discovers to which extent that Maqasid al-Shari'ah values are achievable through the execution of micro-takaful provided by takaful operators in Malaysia.

2. Literature Review

1. The Establishment of Takaful Industry in Malaysia

The concept of insurance dates to around 1750 B.C. with the Code of Hammurabi, describing a form of bottomry, where a ship's cargo could be pledged in exchange for a loan. Repayment of the loan was contingent on a successful voyage, and the debtor did not have to repay the loan if the ship was lost at sea (Beattie, 2023). Later, the concept was slowly developed by Western colonies after the involvement with over-sea trade as the trade being confined to that borne by sea, so they would have amended the contract to cover the risks to which they were exposed, namely risks of losing arising storms, and also from piracy (Trenerry, 2009). It can be said that the growth of British trade in the 17th and 18th centuries had contributed to the development of insurance. Before the foundation of corporations, the first professional insurers were private individuals (Alshammari et al., 2023).

Despite the market of insurance has now become broader, its concept, however, does not meet with the principle of Shari'ah. Conventional insurance involves certain prohibited elements in Islamic transactions, such as *riba* (usury), *maysir* (gambling) and *gharar* (uncertainty) (JAKIM, 2009). Dating back to the 18th century, Muslim jurists had a discussion pertaining to the Islamic perspective on insurance. One of the earliest scholars explicitly discussed on insurance contract was Muhammad ibn Abidin (of the Hanafi school) in 1784. He scrutinised the word *sukrah* (security) was the term used to refer to insurance, stressing on the prohibition to take compensation for any damage of his property.

The discussion on insurance, later, has been explored by the Muslim jurists. In the modern era discussion, jurists such as Muhammad Abu Zahra, Al-Siddiq Muhammad Al-Darir and Mustafa Al-Zarqa, began analysing insurance contracts, and in 1961 in Damascus, their views were presented in Seminar of Jurisprudence in 1972. During the seminar, Muslim scholars proposed to use cooperative insurance in place of commercial insurance in a Legislation Seminar hosted in Libya. Later, the resolution on the non-permissibility of commercial insurance finally came during the First Conference of the OIC Fiqh Academy in 1978. Subsequently, a decision has been issued in the Second Conference of the OIC Fiqh Academy in Jeddah, where the probation of using insurance extended to commercial insurance and favoured cooperative insurance (Alshammari et al., 2023).

The development of takaful industry in Malaysia marked its first appearance in 1980s, providing a Shari'ah compliant option to conventional insurance, as it aligns with the establishment of the first Islamic bank

in 1983 (Bank Negara Malaysia, 2004). The inception and rapid growth of the takaful industry in Malaysia was driven by Muslim communities' dire need to have a Shariah-compliant alternative for existing conventional insurance and global interest in takaful products due to the expansion of various sectors within the Islamic financial system, particularly Islamic banking and capital markets (Al-Habshi & Abdul Razak, n.d). The government in 1982 set up a Special Task Force to study the feasibility of establishing Islamic insurance in Malaysia. Based on the results, a Takaful Act was passed in 1984, and in November 1984, Malaysia incorporated its first takaful operator. The development of takaful sector in Malaysia is perceived through these three key phases:

Table 1: Gradual Approach of Takaful Industries Development

Phase I (1984-1992)	Started with the enactment of a dedicated regulatory law, i.e. the Takaful Act 1984 and the establishment of the first takaful operator in 1984. The primary focus during this period was the establishment of the basic infrastructure for the industry. This Act, which is still in use, is enacted to govern the conduct of takaful business and requires the registration of takaful operators. It also provides for the establishment of Shariah Committees to ensure that the business operations of a takaful operator are in compliance with Shariah principles at all times.
Phase II (1993-2000)	Marked the introduction of competition with the entry of another takaful operator. This period also saw greater cooperation among takaful operators in the region including the formation of the ASEAN Takaful Group in 1995 and the establishment of ASEAN Retakaful International (L) Ltd. In 1997. This has facilitated retakaful (reinsurance) arrangements among takaful operators in Malaysia and in the region, namely Brunei, Indonesia and Singapore.
Phase III (2001-2010)	Began with the introduction of the Financial Sector Masterplan (FSMP) in 2001 which, among other objectives, is to enhance the capacity of the takaful operators and strengthen the legal, Shari'ah and regulatory framework. The section of the FSMP which relates to Islamic banking and takaful is a roadmap towards realising the aspiration of Malaysia becoming an international centre for Islamic finance. This period has so far witnessed an increased pace of development and competition with the licensing of three new operators. To further promote the development of the takaful industry, the Malaysian Takaful Association (MTA), an association for takaful operators, was established in 2002. The MTA aspires to improve industry self

Source: Authors' work

Takaful operates as a form of mutual indemnity in which participants collectively provide protection for one another. Unlike conventional insurance, contributions in takaful are treated as donations, resulting in risk-sharing among the participants (Abdul Aziz et al., 2013). According to Section 2 of the Takaful Act 1984, takaful is defined as a scheme grounded in principles of brotherhood, solidarity, and mutual assistance, offering financial support to participants during specified circumstances of need. This arrangement is established based on the mutual consent of participants to contribute towards such purposes (Ismail et al., 2013).

Takaful has been recognized as an acceptable alternative by the Shari'ah Advisory Council of Bank Negara Malaysia (SAC-BNM, 2010). In contrast to bottomry, where insurance protection was incorporated within the loan rather than as a separate contract, bundling loans with insurance establishes a link between finance and insurance (Alshammari et al., 2023). Takaful operates as an Islamic insurance model grounded in the principles of cooperation and mutual assistance. Under this arrangement, participants collectively agree to support each other in the event of a specified loss. The takaful structure aligns closely with Islamic socio-economic values, promoting benefits for individuals and society at large. While takaful provides coverage similar to conventional insurance, it is distinguished by its focus on risk-sharing, as opposed to the risk transfer model inherent in traditional insurance schemes (Ismail et al., 2013).

2. Low Takaful Market Penetration in Malaysia: A Critical Analysis

Malaysian takaful industry has witnessed significant progress over the past few decades, driven by regulatory measures, macroeconomic stability, digitalisation, and increased awareness of takaful products (Insurance Asia, 2025). This remarkable achievement has established this sector as a global leader in Islamic insurance

and demonstrated how comprehensive regulatory framework, strategic government support, and enhanced consumer awareness can drive sustained sectoral growth. According to [Ahmad Mokhtar et al. \(2017\)](#), the takaful sector has demonstrated resilience even during challenging periods. For instance, the Malaysian takaful industry's sound contribution growth has been led by family takaful, rising by 46.7 percent in 1H21, while general takaful grew by 13.5 percent in the same period ([Fitch Rating, 2022](#)).

Nevertheless, despite these impressive growth figure, the market penetration rate of takaful remains relatively low compared to conventional insurance. Takaful penetration, measured as total contributions as a percentage of Gross Domestic Product (GDP), has remained below expectations despite Malaysia being a global leader in Islamic finance. According to Bank Negara Malaysia (BNM) reports, the takaful penetration rate in Malaysia stood at 18.6 percent in 2021, increased marginally to 20.1 percent in 2022, slightly dropped to 19.6 percent in 2023 and remained constant at 19.6 percent in 2024 ([Bank Negara Malaysia, 2024](#)). While this reflects steady growth, it is still significantly lower than conventional insurance, which hovers around 50% in market penetration. The relatively slow growth of takaful penetration can be attributed to multiple factors, including low public awareness, affordability concerns, product complexity, and limited distribution channels ([Jusoh, 2023](#)).

A critical aspect influencing the penetration rate is the financial literacy of consumers, particularly in understanding the concept and benefits of takaful. Studies indicate that a lack of understanding about risk-sharing mechanisms and the distinction between conventional insurance and takaful hampers participation ([Salman & Kawata, 2022](#)). Public awareness of the importance of having takaful and insurance protection is still low, as 60 percent of the nation's population does not have adequate takaful or insurance coverage ([Daily Mail, 2023](#)). In their study, [Khairi et al. \(2025\)](#) firmly stated that customers undoubtedly consider insurance over takaful due to pricings offered by both sectors. This argument is supported by recent research by [Maduku and Mbeya \(2024\)](#), demonstrating that the concern over the cost of takaful products often discourages customers from purchasing them. Their finding also addresses the that cultural and behavioural factors, such as trust and religious motivation, play a crucial role in consumers' decision-making process regarding takaful subscription ([Maduku & Mbeya, 2024](#)). Unlike conventional insurance, which has extensive market reach and established risk pooling mechanisms, takaful products often carry higher pricing due to underwriting risks and operational costs. A study by [Jahya et al. \(2023\)](#) highlighted that while low-income groups express interest in takaful, the perceived cost deters many from subscribing, making micro-takaful a viable alternative for increasing penetration.

Furthermore, distribution strategies significantly affect market penetration. Takaful operators in Malaysia predominantly rely on *bancatakaful* and agency models, which may not effectively reach underserved and rural populations. Recent developments, such as digital takaful platforms and insurtech innovations, have the potential to enhance accessibility and affordability, thus improving penetration rates ([PwC, 2023](#)). In conclusion, while Malaysia's takaful sector has made commendable strides, achieving deeper market penetration requires a multifaceted approach, including enhanced financial literacy, affordable product structures, and innovative distribution channels. As takaful aligns with Maqasid al-Shari'ah principles, its expansion will contribute to greater financial inclusion and social protection.

3. Micro-Takaful as Crucial Tool for Underprivileged Societies' Financial Sustainability

Micro-takaful represents a specialised financial instrument designed to provide prospective financial protection for low-income earners. It is conceptualised as a takaful product specifically tailored to address the financial protection requirements of economically disadvantaged households ([Bank Negara Malaysia, 2016](#)), served as financial protection that encompasses the capacity to access timely and sufficient financial resources to either cope with substantial expenditures or provide temporary or partial relief from financial hardships arising from unforeseen adverse circumstances. Low-income households refer to impoverished, vulnerable, or lower-middle-income families, particularly those demographic groups that have historically been excluded from conventional insurance and takaful provision ([Saleh & Padzim, 2018](#)).

The implementation of micro-takaful products is widely regarded as a fundamental poverty alleviation mechanism, enabling low-income earners to safeguard their financial capacity and ensure sustainable livelihoods. In alignment with takaful's fundamental objective of protecting the entire ummah (community), micro-takaful products constitute specialised offerings that prioritise public welfare over profit maximisation ([Saleh & Padzim, 2018](#)). This social orientation distinguishes micro-takaful from conventional commercial insurance products and underscores its role as a tool for financial inclusion.

Micro-takaful may be further characterised as the protection of assets and lives against insurable risks affecting target populations, particularly micro-entrepreneurs and economically disadvantaged groups (Ismail et al., 2013). As a form of Islamic micro-insurance, micro-takaful products are specifically designed to address the financial requirements of low-income households, enabling them to manage significant expenditures whilst providing temporary or partial relief from financial adversity. Moreover, these schemes engender a sense of security and serve as a buffer against extreme poverty, preventing vulnerable communities from experiencing further economic deterioration.

The efficacy of micro-takaful initiatives is contingent upon strategic partnerships and collaborative frameworks. Through such alliances, micro-takaful schemes can extend their reach to encompass larger cohorts of potential beneficiaries. Additionally, by offering simplified products at substantially reduced premiums, these schemes can enhance awareness and uptake amongst small and medium enterprise sectors, thereby contributing to broader financial inclusion objectives (Salleh & Padzim, 2018).

4. *Micro-takaful in the light of Maqasid al-Shari'ah*

Within the sphere of Islamic finance, takaful has emerged as a viable alternative to conventional insurance, wherein prohibited elements such as *riba*, *gharar*, and *qimar* are frequently practised (Noordin et al., 2014). Takaful operations are premised upon lawful business practices, with contracts and transactions required to be entirely free from prohibited elements (Harun & Abdullah, 2018). Zain and Ali (2017) assert that takaful possesses the potential to develop into a sustainable safety net for society at large, providing essential protection particularly when confronting natural disasters such as tsunamis or earthquakes. Abdul Aziz et al. (2013) observe that whilst asset loss is unfortunate for owners who require replacements to continue their daily lives, outstanding debts nevertheless remain payable.

Similarly, micro-takaful does not abandon such perspectives but rather adapts to meet the requirements for social well-being and economic stability, particularly amongst underprivileged societies. The establishment of micro-takaful aims to achieve the following objectives:

- (a) immediate temporary relief during financial difficulty, which is most relevant to adverse events where the financial impact is neither extremely high nor permanent, or where micro-takaful serves as a complement to other coping strategies;
- (b) access to financial resources to address sudden substantial expenses, particularly adverse events where the financial impact is higher or permanent, or where micro-takaful constitutes the primary coping strategy; and
- (c) peace of mind derived from the knowledge that financial relief would be available in an accessible and timely manner should an adverse event unexpectedly occur, thereby encouraging households to undertake income-generating activities and improve their standard of living.

From the aforementioned objectives, it can be clearly established that initiatives such as micro-takaful achieve the authentic meaning of *Maqasid al-Shari'ah*. Abdul Aziz et al. (2013) suggest that micro-takaful essentially brings sustainability to individual and family institutions, supporting continuity in the event of death or permanent disability of the primary breadwinner. Through affordable premiums for micro-takaful subscriptions, health and income protection remain accessible to participants. Furthermore, micro-takaful has been perceived as an excellent alternative for those engaged in small and medium enterprise (SME) operations. The availability of appropriate coverage products to protect business entities is essential, particularly to ensure financial stability (Salleh & Padzim, 2018).

As the fundamental characteristic of Islamic insurance is not profit maximisation (Ahmed, n.d.) but rather mutual cooperation founded upon donation-based contracts from participants (Abdul Aziz et al., 2013), it can be established that the realisation of *Maqasid al-Shari'ah* is achieved through its implementation. This represents the foundational concept of *Maqasid al-Shari'ah* in promoting social justice and financial equality across all societal levels. Poverty reduction, healthcare improvement, intellectual preservation, and income and health coverage constitute manifestations of how *Shari'ah* preserves life (*nafs*), wealth (*mal*), progeny (*nasl*), and intellect (*'aql*).

The preservation of religion (*din*) through micro-takaful manifests across multiple dimensions. Primarily, the instrument operates entirely within *Shari'ah*-compliant frameworks, avoiding prohibited elements such as *riba*, *gharar*, and *maysir* (Tahir & Rashid, 2021). This compliance ensures that participants can access financial

protection whilst maintaining their religious obligations and ethical commitments. Furthermore, micro-takaful embodies the Islamic principles of brotherhood (ukhuwah) and social responsibility (mas'uliyah), fostering a sense of shared purpose and mutual support amongst participants. The underlying philosophy of mutual assistance and collective responsibility reflects the communitarian values emphasised in Islamic teachings, thereby strengthening social cohesion and religious identity within communities.

In summary, the integration of micro-takaful and Maqasid al-Shari'ah illustrates the essential aspects of Shari'ah in facilitating humanity's protection of self, progeny (family), assets, and extending mutual assistance to the ummah. Before selecting the most appropriate plan or contract for achieving the maqasid, one must consider whom or what should be covered, when coverage will be provided, and the extent of coverage, all of which are stipulated within the takaful contract. In this regard, [Laldin \(2022\)](#) enhances maqasid thinking by encouraging communities to consider the impact of their decisions. According to him, Maqasid al-Shari'ah entails examining the consequences of decisions made, meaning that before final decisions or rulings are determined on any issues, Maqasid al-Shari'ah requires investigation into the impact of such decisions. This approach is crucial for ensuring holistic decision-making that considers not only the permissibility (halal) of products and services but also ensures they are wholesome (tayyib), noble, beneficial, and protective against harm to society and humanity as a whole.

3. Research Methodology

3.1. Research Design

This study adopts a qualitative research approach which includes two distinct phases, involving library research and interviews. Adopting qualitative research here is significant in providing interpretive messages from diverse research resources. Also, it provides a profundity of knowledge that could not be attained by any quantification method ([Johnson et al., 2006](#)), centred on text, words, feelings and viewpoints ([Levy, 2006](#)). The qualitative research approach is sensible to achieve the objectives of the study since the exploration of micro-takaful awareness, and its practical suggestions should be understood from both theoretical aspect and real experience of the participants who directly involve in the takaful industry.

3.2. Data Collection

For the data collection, this study involves two distinct phases. The first phase involves a thorough document analysis, drawing from official takaful reporting, journals, government policies as well as scholarly works to develop its theoretical framework. Subsequently, the data gained from these references will be analysed using a content analysis approach, it is a method that falls in the interface of observation and document analysis ([Prasad, 2008](#)), for making inference by systematically and objectively identifying specified characteristics of messages. For this study, the approach is relevant in identifying key challenges of micro-takaful awareness among low-income societies in Malaysia.

The second phase consists of interviews with takaful experts and qualified Shari'ah scholars with over five years of experience in the said sector. Interview is a verbal interchange where one person, the interviewer, attempts to elicit information from another person by asking questions ([Longhurst, 2023](#)). To avoid the reputation risk, all interviewees' names and their institutions are not mentioned in this study. All general information regarding interviewees is mentioned in Table 2.

Table 2: List of Sample from the Respondents

	Designation	Institution
IR1	Takaful Adviser	Authorised Takaful Operator
IR2	Takaful Officer	Authorised Takaful Operator
IR3	Shari'ah Scholar	International Islamic University Malaysia
IR4	Shari'ah Scholar	International Islamic University Malaysia
IR5	Shari'ah Scholar	Independent Researcher

For the field work, thematic analysis is applied to engage with the data to identify and interpret patterns within qualitative approaches. This analysis is essential for the study to present its findings as themes. This approach integrates valuable techniques from various theoretical and methodological perspectives, adapting them to

applied research (Guest et al., 2012), and is usable for identifying, analysing and interpreting patterns of meaning 'theme' within qualitative data. Using thematic analysis is important in this qualitative study as it provides accessible and systematic procedures for generating themes where it provides a framework for organising and reporting the researcher's analytic observation (Clarke & Braun, 2017). The approach borrows what some other researchers feel are the most useful techniques from each theoretical and methodological camp and adapts them to an applied research context (Guest et al., 2012). Additionally, this approach aligns with the requirements of the study by enabling flexible communication with selected respondents regarding their perspectives on micro-takaful awareness and potential areas for improvement.

4. Results and Discussion

In this section, this study will provide insights based on the interview sessions with the interview participants, highlighting various issues related to micro-takaful in Malaysia. The data are organized in themes as they can be perceived in the following discussion.

4.1 Exploration of the Micro-Takaful Model and Its Role in Providing Financial and Health Protection to Low-Income Societies

All respondents concur that micro-takaful represents a viable alternative for takaful operators in providing financial and health protection to targeted low-income communities in Malaysia. IR1 provides a comprehensive overview of micro-takaful's conceptual foundation and protective scope, affirming that micro-takaful operates upon traditional takaful principles whilst offering substantial support mechanisms for economically disadvantaged individuals. The protection framework encompasses multiple risk categories, including life-related risks, debt obligations, critical illness coverage, and medical expenditure protection.

Crucially, IR1 emphasises the targeted nature of micro-takaful, noting its specific design orientation towards low-income demographics, particularly those categorised within the B40 income group. This targeted approach ensures that individuals with constrained financial resources can access fundamental protection services through the micro-takaful framework, thereby addressing a critical gap in financial protection coverage for economically vulnerable populations.

IR2 focuses primarily on accessibility mechanisms and structural barriers within the takaful sector, articulating that micro-takaful operates through minimal monthly contribution requirements, which serves to enhance accessibility for individuals with limited financial means. This reduced contribution structure directly addresses affordability concerns that traditionally exclude low-income groups from protection schemes. The respondent identifies two primary impediments to broader takaful adoption: insufficient awareness amongst target populations and prohibitive cost structures. IR2 suggests that micro-takaful's reduced financial burden represents a viable solution to cost-related barriers, with the potential consequence of increased participation rates across the target demographic.

IR3 provides a concise assessment of micro-takaful's viability as an alternative protection mechanism, characterising micro-takaful as a "promising alternative" based on its fundamental requirement for only modest contributions from participants. This perspective emphasises the practical advantages of the micro-takaful model in terms of financial accessibility, reinforcing the theme identified by other respondents regarding the importance of reduced financial barriers in extending protection coverage to economically disadvantaged populations.

Insights from the interviews indicate that micro-takaful functions as a powerful tool for safeguarding health and wealth for both individuals and families. Through affordable premiums, participants can secure vital benefits during crises, particularly when the primary breadwinner encounters an unfortunate event. A poignant example highlighted in a *Sinar Harian* report from 16 July 2021 describes a single mother who struggled to support her children following her husband's death, as he was the family's sole breadwinner and no wealth protection had been established. Another case reveals a wife experiencing financial hardship due to her inability to settle her late husband's debts. Whilst micro-takaful may offer less comprehensive coverage compared to other takaful products, it provides crucial support by protecting beneficiaries' income. Beyond financial relief, the benefits can serve as seed capital for entrepreneurship, enabling families to establish new ventures and cover monthly expenses.

4.2 *Evaluation of Barriers to Increasing Awareness and Understanding of Micro-Takaful Amongst Low-Income Communities*

Despite its promising alternative to traditional takaful, all respondents addressed challenging factors constraining the advancement of micro-takaful schemes in Malaysia. They outlined challenges to increasing awareness from multiple perspectives, including individual, takaful operator, and governmental considerations.

IR1 and IR5 identify fundamental economic constraints that position takaful as a secondary consideration for low-income earners. They explain that individuals within this demographic typically regard takaful as a "last resort" due to constrained financial circumstances and the imperative to prioritise essential living expenses. This perspective highlights competing demands on limited household budgets, where necessities take precedence over financial protection products.

Furthermore, IR1 draws attention to the promotional disparity between micro-takaful and traditional takaful products, noting that micro-takaful receives considerably less promotional attention compared to conventional takaful offerings, resulting in reduced visibility and awareness amongst potential participants. IR1 suggests that enhanced promotional efforts specifically targeting micro-takaful could substantially improve awareness levels and subsequently encourage greater adoption rates amongst the target demographic.

IR2 centres the analysis on financial literacy as the primary impediment to effective micro-takaful promotion, emphasising that limited financial understanding amongst target populations creates substantial challenges in communicating the fundamental benefits and value propositions of takaful plans. This literacy deficit becomes particularly problematic when attempting to explain the mechanisms and advantages of financial protection products to individuals with minimal exposure to such concepts. The respondent further identifies the inherent complexity of takaful products as an exacerbating factor that compounds communication challenges.

IR3 provides a comprehensive assessment of promotional inadequacies across multiple stakeholder levels, identifying insufficient promotional efforts by takaful operators, agents, and governmental bodies as key factors hampering subscription encouragement. This multi-level promotional deficit suggests a systemic failure in creating awareness and generating interest in micro-takaful schemes across the relevant institutional landscape. Additionally, IR3 highlights the dual challenge of inadequate literacy and awareness amongst low-income earners regarding the importance of both health and wealth protection, noting that many individuals within this demographic perceive micro-takaful as wasteful, primarily due to uncertainty regarding the timing and manner in which they might derive benefits from their subscriptions.

4.3 *Innovative Strategies for Micro-Takaful Uptake*

The study findings underscore the critical necessity for comprehensive strategic interventions to promote micro-takaful awareness amongst low-income demographics. The respondents collectively emphasise that effective micro-takaful penetration requires collaborative efforts involving government bodies, takaful operators, and participants themselves, necessitating a coordinated approach to develop and implement strategic initiatives.

IR1 advocates a structured approach centred on collaborative educational initiatives and economies of scale, proposing that government and private sector entities should organise targeted seminars designed to inform potential participants about micro-takaful benefits and opportunities. The respondent particularly emphasises the strategic advantage of group plans over individual subscriptions, noting that larger-scale takaful arrangements can secure more competitive pricing structures compared to individual contributions. IR1 suggests that companies could establish micro-takaful group plans, which would typically offer superior cost-effectiveness relative to individual arrangements, thereby enhancing both pricing accessibility and coverage comprehensiveness.

IR2 emphasises the imperative for comprehensive collaboration amongst government bodies, takaful operators, and private sector entities to ensure micro-takaful remains highly accessible for low-income populations. The respondent advocates for innovative marketing strategies that prioritise clear, simplified communication of micro-takaful concepts, ensuring that complex financial protection mechanisms are presented in understandable formats for target audiences. A significant component of IR2's recommendations involves leveraging digital platforms to enhance financial inclusion, recognising the potential of technology-enabled outreach to reach previously underserved populations.

IR3 adopts a more prescriptive approach, advocating for regulatory intervention to mandate micro-takaful participation amongst government employees. The respondent argues that the current period presents an

opportune moment for governmental action to enhance and enforce new regulations requiring public sector employees to invest in micro-takaful schemes, thereby creating a substantial captive market whilst demonstrating governmental commitment to the product.

From the interview sessions, this study humbly suggests that authorities and takaful operators consider thorough discussions regarding the need to restructure takaful fund management. This would help ensure the adequacy of micro-takaful funds and provide a practical means to enhance the spirit of mutual assistance (*ta'awun*) amongst takaful participants. One of the barriers restraining micro-takaful advancement is inadequate risk funding. Since micro-takaful's purpose is to provide financial protection in the event of accidents or death for the poor and disadvantaged, ensuring risk fund adequacy is critically important (Ghani et al., 2021). Study from Yakob and Rahman (2017) suggests that individuals in the B40 group contribute between RM21 and RM30 per month towards takaful policies. Additionally, many target customers for micro-takaful are informal sector workers (Ndurukia et al., 2017; Rom & Rahman, 2012). This seemingly modest amount can affect takaful operating companies' risk funds, which negatively impacts micro-takaful industry growth (Ghani et al., 2021).

Recognising the funding challenges addressed by takaful operators, several proposed suggestions facilitate operators in handling such issues. Ghani et al. (2021) suggests using zakat to enhance micro-takaful funds. Hence, alternative funds, such as zakat funds, should be developed and expanded to provide greater benefits and assistance to larger numbers of the poor. In using zakat funds for micro-takaful, contributions are donated and owned collectively by micro-takaful participants, who are also amongst zakat recipients (Mikail et al., 2014). Beyond zakat, waqf represents another avenue for use in micro-takaful (Kamal et al., 2020). This alternative depicts micro-takaful participants as waqf beneficiaries. However, waqf-based takaful models differ from waqf-based micro-takaful. For the latter, takaful operators serve as waqf managers alongside takaful funds and are entitled to wakalah management fees (Htay et al., 2015). In waqf-based micro-takaful, sole waqf management is required under State Religious Islamic Councils (SRICs) control.

4.4 Impact of Micro-Takaful Awareness on Financial and Health Security

Interview respondents provide varied assessments of micro-takaful's current status and future prospects, revealing both optimistic projections and persistent structural challenges that continue to impede widespread adoption amongst target demographics. IR1 acknowledges the current perception of takaful and micro-takaful as secondary financial considerations for many individuals whilst drawing attention to international best practices that suggest alternative approaches. The respondent notes that several developed countries have implemented mandatory takaful or similar protection schemes, indicating more advanced recognition of financial protection mechanisms' fundamental importance within these jurisdictions.

IR2 adopts a pragmatic approach by acknowledging persistent challenges of low awareness levels whilst simultaneously recognising tangible benefits that micro-takaful provides to low-income communities. The respondent emphasises that despite limited understanding, financial protection mechanisms offer considerable peace of mind for economically vulnerable populations. Specifically, IR2 highlights practical advantages of micro-takaful coverage, noting that participants gain access to private healthcare facilities and expedited treatment services whilst preserving available funds for other essential expenditures.

IR3 provides a more sobering assessment based on empirical evidence from regulatory authorities, noting that recent data indicates minimal impact from micro-takaful initiatives. The respondent attributes this limited effectiveness primarily to insufficient public awareness regarding protection needs, creating cyclical challenges affecting multiple stakeholders within the micro-takaful ecosystem. Significantly, IR3 identifies operator hesitancy as a consequential challenge, explaining that takaful operators demonstrate reluctance to promote micro-takaful schemes due to financial sustainability concerns.

The 2021 flood disaster underscored this issue starkly. Despite massive RM6.1 billion in total losses, only RM2 billion was covered by insurance, leaving the government to absorb the remaining burden. Alarming, only 5 per cent of affected vehicles had flood protection. The Malaysian Takaful Association argues that had takaful coverage been more widespread, these losses could have been substantially mitigated (Bernama, 2023). Takaful's core principle of mutual aid and support through broad networks could have provided crucial assistance in such crises, underscoring the urgent need for increased public education on takaful and insurance coverage importance.

5. Conclusion and Recommendation

The research concludes the awareness among low-income earners about wealth and health protection is low. Addressing this issue is important, as alleviating poverty is one of the Shari'ah objectives and remains a government priority. Micro-takaful presents a viable solution for providing wealth and health coverage to low-income earners groups. This coverage extends to beneficiaries' families when participants designate nominees as recipients of the benefits. To promote micro-takaful, it is essential for all stakeholders including the government and takaful operators to cooperate. This can be achieved through various platforms such as financial forums, digital advertising, and regulatory advocacy, to engage low-income earners groups.

Funding alternatives like *zakat*, *waqf* and CSR, or government subsidies can help address the financial inadequacy in micro-takaful funds. In conclusion, even modest benefits can significantly aid low-income earners groups in managing their financial responsibilities, especially after the death of their primary breadwinner in family.

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Fostering A Creative Economy Ecosystem Through Collaborative Efforts of Three Sectors: An Ism Approach

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Abstract

This study aims to support the development of a sustainable creative economy by analyzing and identifying critical elements in the collaboration between creative Micro, Small, and Medium Enterprises (MSMEs), Islamic Microfinance Institutions (SMIs), and Zakat Institutions (ZIs) in Indonesia. This partnership addresses socioeconomic challenges such as community empowerment and poverty reduction through enhanced access to Sharia-based financing, human resource development, and improved partnership networks. Using a mixed-methods approach combining Interpretive Structural Modeling (ISM) and qualitative methods like interviews and direct observation, the findings highlight key drivers of success: government regulations, financial availability, infrastructure, human resource training, innovative product development, and social support. Recommendations include enhancing financial literacy, increasing access to Sharia-based funding, strengthening regulatory frameworks, improving infrastructure, and fostering innovation in MSME products.

Keywords: Creative Economy, MSMEs, ISM, SMIs, ZIs

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1. Introduction

One of the main forces behind economic growth in the majority of the world's nations is the creative economy (Rodríguez, 2019). The world has, regrettably, evolved extremely swiftly in this age of globalization. In this setting, boosting a region's or nation's competitiveness has become more and more dependent on the creative economy, which encompasses the fields of art, culture, design, technology, and innovation (Yan & Liu, 2023; Daly & Frikha, 2015). A further reason for the rise of the creative economy is its capacity to generate economic added value through innovation, creativity, and the effective use of abundant local resources (Lazić, 2023). Conversely, MSMEs frequently face barriers to accessing larger markets, financing, or other resources necessary for long-term, sustainable growth, notwithstanding their significance to the economy (Rajamani et al., 2022).

In most countries, especially developing ones, MSMEs now form the foundation of the economy. MSMEs have the ability to create innovative goods and services as well as establish companies that are rooted in the knowledge and culture of their community (Muhammad et al., 2023). Islamic finance, including Sharia-based instruments, offers potential for funding creative industries while adhering to Islamic principles (Hassanain, 2015). The development of Sharia-compliant creative industries can promote sustainable economic growth, create employment opportunities, and generate social benefits (Hassanain, 2015). Islamic crowdfunding

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platforms have shown promise in supporting business development for startups and MSMEs, providing easier access to financing compared to traditional banking (Mustafida et al., 2021). Interestingly, non-Muslim entrepreneurs are increasingly interested in Islamic bank financing, influenced by factors such as social influence, reputation, promotion, and services (Soelistyo, 2022). These findings suggest that Islamic finance mechanisms can play a significant role in fostering inclusive growth in the creative economy sector, particularly in Muslim-majority nations.

Islamic microfinance institutions and zakat-based systems offer promising approaches to poverty alleviation and human development in Muslim countries. These institutions operate on Shariah principles, prohibiting interest and focusing on halal activities (Mikail & Adekunle, 2020). Integrating zakat, awqaf, and Islamic microfinance can create sustainable models that address multiple facets of poverty (Hassanain, 2015). These integrated approaches can enhance financial inclusion, improve human capital, and provide access to micro-credit for the productive poor (Usman & Tasmin, 2016). Zakat and awqaf institutions are regaining relevance in socio-economic development, contributing to community asset generation and capacity building (Usman & Tasmin, 2016). While some argue for prioritizing profitability over Shariah compliance, others maintain that adherence to Islamic principles is crucial for the industry's identity and success (Mikail & Adekunle, 2020). Overall, these models demonstrate potential for achieving both Shariah compliance and sustainability in microfinance operations.

Sharia-based financing plays a crucial role in supporting micro, small, and medium enterprises (MSMEs) in Indonesia's creative economy. MSMEs face challenges such as limited capital, low human resource quality, and lack of technological mastery (Lubis, 2016). Sharia-based financial institutions offer an alternative to conventional methods, providing access to Islamic financing principles like profit-sharing (Bhakti et al., 2013). This approach helps overcome capital limitations and supports MSME development (Putri, 2021). However, barriers to full implementation of sharia-based practices include Islamic banking financing, human resources, and government relations (Lahamid, 2018). To address these issues, recommendations include improving sharia business knowledge, building business networks, and adhering to Islamic norms (Lahamid, 2018). Additionally, partnership programs for non-bankable businesses, management support through advisors, and increased popularity of Islamic financial institutions are suggested to enhance MSME growth and reduce poverty (Lubis, 2016).

One effective method for examining intricate interactions between components in different systems is the Interpretive Structural Modeling (ISM) approach (Attri et al., 2013). It has been used to analyze collaborative supply in SME clusters (Wu & Xiao, 2020), identify critical success factors for SMEs in Indonesia (Kusrini et al., 2019), and look into obstacles to cooperation among SMEs in Pakistan that manufacture auto parts (Khalid et al., 2016). Finding pertinent variables, building a structural self-interaction matrix, generating a reachability matrix, and deriving a hierarchical structural model are all steps in the ISM technique (Attri et al., 2013). This method has assisted researchers in identifying important elements that impact the success of SMEs, including entrepreneurial spirit, motivation, and educational attainment (Kusrini et al., 2019), as well as obstacles to cooperation (Khalid et al., 2016). ISM helps managers and policymakers overcome the difficulties encountered by SMEs and foster productive collaboration by offering a formal framework for examining intricate interactions.

The interpretative structural modeling (ISM) approach becomes relevant in this research. ISM is an analytical method that helps identify and understand the structure of relationships among complex factors and can assist in developing effective collaboration models between MSMEs, ZI, and SMI to enhance the creative economy. We expect this research to enhance our understanding of the dynamics of interactions between related sectors and provide deeper insights into strengthening this collaboration for inclusive and sustainable creative economy growth.

2. Literature Review

Agrawal & Narain (2023), Gupta & Singh (2022), Souhankar et al. (2023), Rana et al. (2023), analysis of digital payment usage; flood management; strategies for electricity conservation; Agrawal & Narain (2023) and analysis of factors influencing economic sustainability are just a few of the scientific fields and applications that have made extensive use of Interpretive Structural Modelling (ISM) (Farooq et al., 2023). The Interpretative Structural Modelling (ISM) approach has been extensively used in Islamic social finance research in recent years. ISM enables researchers to map the relationships between variables that affect complex systems and assists in identifying critical components that determine a system's success or failure.

Rusydia (2018) research is among the several that use ISM to study the problem of zakat management. He examined the variables affecting Indonesian zakat management using ISM. The study found that a number of variables, including government policies, community financial literacy, and zakat organizations' capacity to efficiently handle zakat monies, are important components of zakat management. Since strict laws can guarantee that zakat is managed transparently and in compliance with Sharia law, government policy is thought to be the most important aspect.

Madlulah (2023) investigation then employed ISM to investigate the variables affecting productive zakat as a means of promoting the poor's economic empowerment. The relationship between the financial literacy of mustahik (zakat recipients), the policies of zakat institutions, and the assistance of the financial infrastructure is mapped in this study using ISM. The findings of the research indicate that in order for beneficiaries of productive zakat to manage and use it to its fullest potential, financial literacy is a critical component that needs to be enhanced. Furthermore, the proactive strategies of zakat organizations in educating mustahik about finance are crucial to the success of fruitful zakat programs.

Rusydia (2018) which examines the growth of cash waqf in Indonesia, makes use of ISM in the context of waqf. They employ ISM to map the factors, including as governmental laws, community waqf literacy, and waqf institutions' managerial capabilities, that affect the success of cash waqf administration. The findings of this study indicate that in order to fully realize the potential of cash waqf, it is imperative to enhance the presence of favorable government rules and encourage active community involvement in waqf. Furthermore, the advancement of technology and digital platforms for cash waqf has emerged as a crucial element that facilitates community participation in waqf.

Another study carried out by Khalid et al. (2016) used the ISM to examine the role of time in the development of local economic development in Malaysia. This study reveals that various factors, including access to the local economy, the support of the regional government, and the non-compliance of Islamic banks with local currency regulations, significantly harm the success of local economic development. ISM is used to identify the ways in which each element of the system is interconnected and to develop strategies to increase the efficiency of time in managing the local economy.

Meanwhile, Adjar et al. (2020) conducted a study on Islamic Microfinance Institutions (SMI) utilizing ISM to examine how SMI assist MSMEs in Maroco. The factors, such as financial infrastructure, financial literacy, governmental regulations, and support from zakat organizations, that affect access to sharia financing are mapped using ISM. The study's findings indicate that SMI's ability to successfully offer sharia finance services to MSMEs is primarily influenced by two factors: financial literacy and infrastructure. More comprehensive teaching initiatives by SMI and affiliated institutions are required because MSMEs frequently face challenges in utilizing sharia financing to their full potential due to low financial literacy.

In a follow-up study, Romarina (2016) employed ISM to examine how SMI, zakat institutions, and MSMEs work together to foster the growth of Indonesia's creative sector. This study finds that government regulations, funding availability, training programs for human resources, and product innovation are some of the major factors that affect how well a cooperation works. ISM gives academics insights into tactics that may be applied to improve synergy between Islamic financial institutions and the MSME sector as well as aids in the mapping of the relationships between each variable. In the management of the Islamic social finance system, sustainability is one of the key concerns.

The application of ISM has shown to be beneficial in determining the elements that affect the viability of Islamic social finance initiatives, such as microfinance organizations, zakat, and waqf. The factors influencing the sustainability of economic projects sponsored by waqf and zakat in Pakistan were analyzed using ISM in a study by Farooq et al. (2023). This study discovered that the program's longevity is mostly dependent on three factors: community involvement, innovation in Sharia financial products, and government legislation. ISM offers a clearer picture of how to preserve the sustainability of Islam-based social financing economic programs and aids researchers in mapping the relationships between these variables.

Prior research pertaining to Interpretative Structural Modelling (ISM) in Islamic social finance has predominantly centred on the administration of Islamic Microfinance institutions (SMI), waqf, and zakat within the framework of poverty reduction and economic empowerment. These studies, however, have not particularly looked at how different sectors, particularly SMI, ZI, and creative MSMEs, collaborate to facilitate the growth of the sharia-based creative economy. Prior studies have also given more attention to specific areas of social finance without taking into account how these areas work together. Furthermore, the wider function that Islamic finance plays in fostering innovation and the expansion of imaginative MSMEs has not yet been adequately

explored by most studies.

The infrastructure and technology supporting the ecosystem of the sharia-based creative economy have also not received enough attention, according to a number of earlier research. Without taking into account how technology and logistical infrastructure might be integrated to facilitate the growth of creative MSMEs, previous research has concentrated more on the digitization of zakat or waqf management. In the framework of partnership between ZI, SMI, and creative MSMEs, financial literacy and geographic challenges particularly in distant areas have not yet received much attention.

By examining the cooperation of three sectors (ZI, SMI, and creative MSMEs) in the growth of a sharia-based creative economy and emphasizing the significance of infrastructure, technology, and financial literacy, this study aims to close the research gap. This study offers a fresh viewpoint on how to map the dynamics of inter-sector relationships using ISM in order to support a sustainable creative economy.

3. Research Methodology

3.1 Sampling Method and Data Collection

This study employs the Interpretive Structural Modeling (ISM) method, as it allows for the identification of interrelationships among factors within a complex system and organizes them into a hierarchical structure. This approach is considered appropriate for formulating the partnership model between creative Micro, Small, and Medium Enterprises (MSMEs), Islamic Microfinance Institutions (SMIs), and Zakat Institutions (ZIs).

To facilitate the ISM analysis, the study collected data from three primary groups of participants: managers of Islamic Microfinance Institutions (SMI), representatives from the Zakat Institution (ZI), and players from Creative Micro, Small, and Medium Enterprises (MSMEs). The creative MSMEs included in the sample are those that operate in the creative economy and get funding or support from SMI and ZI. The sampling process took into account the participants' active participation in joint initiatives between MSMEs, SMI, and ZI. The existence of MSMEs in diverse regions particularly those that reflect varied geographic conditions is another criterion taken into account in order to identify variances in obstacles and possibilities. The number of active entrepreneurs and representatives from ZI and SMI who are engaged in the process of sharia financing and MSME empowerment is what determines the sample size. The sample size in qualitative research is frequently set until it reaches information saturation, at which point doing more interviews yields no appreciable amount of new data.

Creative MSME actors, ZI representatives, and SMI management participated in semi-structured interviews. Through these interviews, we hope to learn more about the benefits and challenges that come with collaboration, as well as the aspects that they believe make a collaboration successful. Semi-structured interviews were conducted between June and July with 20 key informants representing creative MSME actors, LAZ administrators, and LKMS management. Each interview was carried out face-to-face and lasted approximately 20–30 minutes, allowing for in-depth exploration of the participants' experiences and perspectives.

Researchers can delve deeper into subjects that come up throughout the conversation in semi-structured interviews. In 2023, [Rana et al. \(2024\)](#), to confirm and delve deeper into the results from the interviews, Focus Group Discussions (FGD) were held with experts and practitioners from related fields. A Focus Group Discussion (FGD) was conducted in [month/year], involving [number] participants consisting of LAZ practitioners, LKMS managers, MSME actors, and academics. The session lasted for approximately [duration] and was facilitated by a moderator. During the discussion, the factors previously identified from the literature and interviews were confirmed and further elaborated through participants' interactions. Important factors that have been determined from the literature and preliminary data are also discovered and confirmed using this FGD. The documentation for the study was gathered from scholarly journals, yearly reports, and other pertinent sources, including government directives about sharia financing and the creative economy. Additional viewpoints are offered by this documentation research to supplement the basic facts ([Farooq et al., 2023](#)).

3.2 Research Instrument

The relationships between the elements that affect cooperation and collaboration within it are analyzed and modeled using Interpretive Structural Modeling (ISM). The following procedures are part of the data analysis technique used:

1. Qualitative Analysis

Qualitative analysis was performed on the semi-structured interview data. The researcher finds the major themes from the interview transcripts during the first step, which is coding. These themes have to do with things like government regulations, funding availability, and training programs for human resources that affect cooperation. Either hand coding or qualitative data analysis software like NVivo are used for coding (Huda, 2023). Data from the Focus Group Discussion (FGD) was evaluated in order to strengthen and confirm the conclusions drawn from the interviews. The results of the focus group discussion (FGD) validate key variables and offer more information about the dynamics of cross-sectoral collaboration (Amini & Alimohammadlou, 2021).

2. Analysis of Interpretive Structural Modeling (ISM)

The Structural Self-Interaction Matrix (SSIM) was developed. The researcher used the FGD and interview data to identify the key elements, and then created SSIM to map the correlations between the variables. Symbols like "V," "A," "X," and "O" are used by SSIM to show the contextual relationships between the system's variables. These symbols represent the degree to which one variable is more, less, or equally influential as another (Gupta & Matharu, 2022).

3. Transform into a Reachability Matrix

The next stage is to transform the SSIM into a Reachability Matrix after it has been constructed. This matrix is binary, where "0" denotes no relationship between two variables and "1" denotes a relationship between them. The degree of impact (driving power) and dependence of each variable in the cooperation system are then examined using this reachability matrix (Gupta & Matharu, 2022).

4. Level Partitioning

Partitioning at the level of separation. Currently, the variables are grouped according to their influence and dependence into multiple hierarchical layers. While the variables at lower levels have greater dependence on one another, the variables at the top level are the most significant and independent of one another. This procedure aids in comprehending the system under analysis's hierarchical structure (Guan et al., 2020).

5. Cross-Impact Analysis Analysis Matrix (MCIA)

Variables are categorized using MICMAC according to how dependent and influential they are. The variables are split into four quadrants as a result. depending (depending on other variables), Linkage (highly interlinked with other variables), Autonomous (independent, with little influence, and not greatly affected by other variables), and Independent (has a significant impact on the system). In order to improve collaboration, the MICMAC analysis assists in prioritizing the required actions on important variables (Rusydiana, 2018; Farooq et al., 2023).

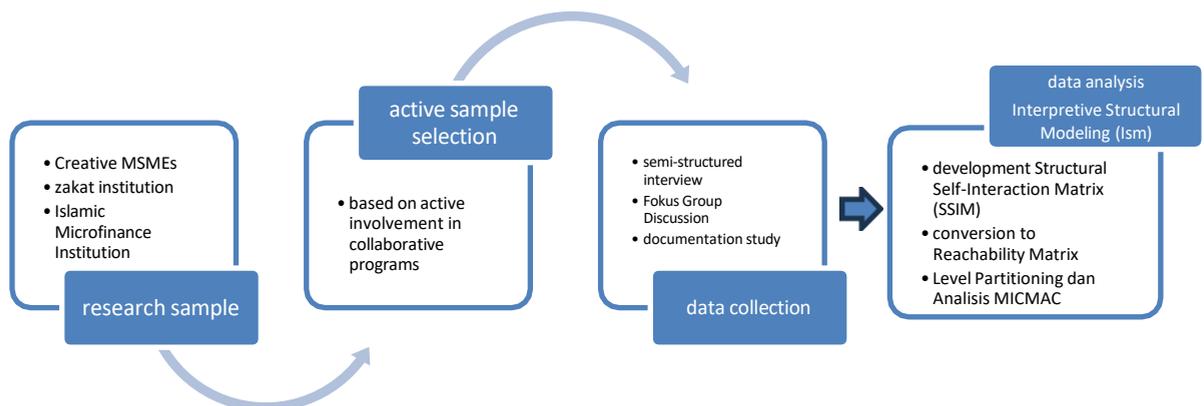


Figure 1: Study Approach

4. Result and Discussion

4.1 Structural Self-Interaction Matrix (SSIM)

An essential tool for mapping and comprehending the connections between the components of a system is the Structural Self-Interaction Matrix (SSIM). The *Zakat Institution* (ZI) and the Islamic Microfinance Institution (SMI) work together to encourage creative MSMEs, and SSIM identifies important aspects and the interactions that these factors have with one another. Using four symbols V, A, X, and O the contextual links between variables are examined through Focus Group Discussions (FGD). A denotes the opposite, X denotes equal influence, O denotes no discernible relationship, and the V symbol shows that the element in the row is more dominating than the column. Key elements supporting the expansion of the creative economy are described in each of the elements A1 through A10.

Table 1. Structural Self-Interaction Matrix (SSIM)

No	Variable Description	a	b	c	d	e	f	g	h	i	j
A	Government Policies & Regulations		A	A	A	A	A	A	A	A	A
B	Access to Finance			X	A	A	A	X	A	X	A
C	Infrastructure and Technology				X	X	A	A	X	X	V
D	Human Resources & Training					X	X	X	X	V	V
E	Networks and Partnerships						X	X	X	X	V
F	Marketing and Market Access							X	X	V	V
G	Community and Social Support								X	V	V
H	Innovation and Adaptation									V	V
I	Logistics Infrastructure										V
J	Geographical Environmental Change										

Note:

V when rows are more dominant than columns; A when columns are more important than rows; X when rows and columns have equal influence; and O when there is no significant relationship between the elements

4.2 Reachability Matrix

After the SSIM is formed, the symbols V, A, X, and O are transformed into a binary matrix known as the Reachability Matrix. At this point, the SSIM represents each contextual relationship in binary form, as follows:
 1 = denotes the existence of a connection between two components.
 0 = denotes that there is no connection between the two components.

Table 2. Initial Reachability Matrix

I,j	a	b	c	d	e	f	g	h	i	j
a	1	0	0	0	0	0	0	0	0	0
b	1	1	1	0	0	0	1	0	1	0
c	1	1	1	1	1	0	0	1	1	1
d	1	1	1	1	1	1	1	1	1	1
e	1	1	1	1	1	1	1	1	1	1
f	1	1	1	1	1	1	1	1	1	1
g	1	1	1	1	1	1	1	1	1	1
h	1	1	1	1	1	1	1	1	1	1
i	1	1	1	0	1	0	0	0	1	1
j	1	1	0	0	0	0	0	0	0	1

In the binary matrix or Reachability Matrix generated from the above SSIM, it is evident that A1 (Government Policies & Regulations) has a dominant relationship with all other elements but is not influenced by other elements. A2 (Access to Financing) shows a balanced relationship with several elements, and is influenced by policies, infrastructure, and technology, but has a significant impact on other elements such as Access to Financing (A2) and Logistics Infrastructure. (A9).

Other elements such as A3 (Infrastructure and Technology), A4 (Human Resources & Training), and A5 (Networks and Partnerships) have increasingly broader relationships in line with their roles in supporting collaboration between ZI and SMI. For example, A4 has full relationships with all elements, indicating the importance of training and human resource development in strengthening the system. This matrix will serve as the basis for the next stage, which is Level Partitioning, aimed at identifying the hierarchical levels of those elements within the system.

Table 3. Final Reachability Matrix

I,j	a	b	c	d	e	f	g	h	i	j	Driver power
a	1	0	0	0	0	0	0	0	0	0	1
b	1	1	1	0	0	0	1	0	1	0	5
c	1	1	1	1	1	0	0	1	1	1	8
d	1	1	1	1	1	1	1	1	1	1	10
e	1	1	1	1	1	1	1	1	1	1	10
f	1	1	1	1	1	1	1	1	1	1	10
g	1	1	1	1	1	1	1	1	1	1	10
h	1	1	1	1	1	1	1	1	1	1	10
i	1	1	1	0	1	0	0	0	1	1	6
j	1	1	0	0	0	0	0	0	0	1	3

The relationships between the components of the cooperative system between Islamic Microfinance Institutions (SMI) and Zakat Management Institutions (ZI) to promote innovative Micro, Small, and Medium-Sized Enterprises (MSMEs) are shown in Table 4.2.3.2's Final Reachability Matrix. The Driver power value of each element is also displayed in this table, indicating the degree to which that element influences other elements within the system.

With a low Driver power of 1, variable "a" (Government Policies & Regulations) has very little effect over other variables. This suggests that the strategy might only have an effect on a small number of system components. With a Driver power of 5, variable "b" (access to financing) has a stronger influence than variable "a," but it is still not as strong as other variables. Driver power for variables "c" through "h" is strong, ranging from 6 to 10. This shows that these variables, such as Infrastructure and Technology, HR & Training, Networks & Partnerships, Marketing, Social Support, and Innovation, play a key role in influencing the entire system. Variable "j" (Geographical Environmental Change) has a Driver power of 3, which means its influence is limited on the overall system. High Driver power variables (d to h, for example) are often the ones that have the biggest effects on the collaboration system between ZI and SMI. Low driver power variables (such a and j) suggest that other factors may have a greater influence on them and that they are not the primary drivers in this system.

4.3 Level Separation

The Level Separation Stage in Interpretive Structural Modeling (ISM) is carried out after the formation of the Reachability Matrix. At this stage, the existing variables are grouped into the Reachability Set, Antecedent Set, and Intersection Set. The reachability set is a collection of variables influenced by a particular variable, including the variable itself. This reflects the extent to which a variable can affect other variables in the system. The antecedent set is a collection of variables that influence a specific variable.

This includes all variables that have an impact on that variable, and the intersection set consists of the variables that are present in both sets (reachability and antecedent). If a variable is in both sets, it is considered

part of the top elements in the ISM hierarchy. Once the same variable between the reachability set and the antecedent set is found, that variable will be at the top level in the hierarchy, as it is no longer influenced by other variables.

This level separation stage is important for understanding how each element in the collaboration system (between ZI and SMI) influences and is influenced by other elements. In the end, the resulting hierarchy will help in identifying the order of priority within the system, from the most fundamental elements to the most influential ones.

Table 4. Iteration 1

Variable	Reachability	Antecedent Set	Intersection Set	Level
a	a	a,b,c,d,e,f,g,h,i,j	a	1
b	a,b,c,g,i	b,c,d,e,f,g,h,i,j,	bb,c,g,i,	2
c	a,b,c,d,e,h,i,j	b,c,d,e,f,g,h,i	b,c,d,e,h,i,	3
d	a,b,c,d,e,f,g,h,i,j	c,d,e,f,g,h	c,d,e,f,g,h	3
e	a,b,c,d,e,f,g,h,i,j	c,d,e,f,g,h,i	c,d,e,f,g,h,i	3
f	a,b,c,d,e,f,g,h,i,j	c,d,e,f,g,h	c,d,e,f,g,h	3
g	a,b,c,d,e,f,g,h,i,j	b,d,e,f,g,h	b,d,e,f,g,h	3
h	a,b,c,d,e,f,g,h,i,j	c,d,e,f,g,h	c,d,e,f,g,h	3
i	a,b,c,e,i,j	b,c,d,e,f,g,h,i	b,c,e,i	2
j	a,b,i	c,d,e,f,g,h,i,j	b,i	2

Using Interpretive Structural Modeling (ISM), the interpretation of Table 4, which displays the outcomes of Iteration 1 in the Level Separation stage, can be explained as follows:

Variable Grouping

This table contains variables from a to j that have been grouped into three sets: Reachability Set, Antecedent Set, and Intersection Set. This grouping helps in understanding the relationships between the variables present in the collaboration system between the Zakat Management Institution (ZI) and the Islamic Microfinance Institution (SMI).

Reachability Set

The Reachability Set shows the variables influenced by each variable. For example, variable 'a' only affects itself, while variable 'b' affects a, b, c, g, and i. This shows that certain variables have a broader influence compared to others.

Antecedent Set

The variables that affect a certain variable are displayed in the antecedent set. The variable 'b', for instance, has a number of other variables influencing it, as seen by the fact that its antecedents include b, c, d, e, f, g, h, i, and j. This gives a general idea of how intricately the system's variables interact with one another.

Intersection Set

Reachability and Antecedent are the two sets in which the variable Intersection Set is present. Since variable 'a' is unaffected by other variables and is the only one in Intersection Set level 1, it is at the top of the hierarchy in this instance.

Level of Hierarchy

These findings show that a large number of variables, including c, d, e, f, g, and h, are at level 3. This suggests that two factors are mutually influential and occupy the same spot in the hierarchy. The variables 'b' and 'i', on the other hand, are at level 2, meaning that while they have an influence, it is not as big as that of the variables at level 3. The structure and dynamics of the collaboration system between ZI and SMI are better understood because to the level separation carried out in this ISM. Managers can create more effective ways to improve collaboration and optimize each institution's contributions by determining the most fundamental and

influenced elements. When developing policies and initiatives pertaining to the support of creative MSMEs, elements at the top level can be given priority.

4.4 Formation of Interpretive Structural Modeling (ISM)

The variables influencing the collaboration between Zakat Management Institutions (ZI), Islamic Microfinance Institutions (SMI), and creative sector MSMEs are grouped into four different quadrants based on driver power and dependence, as shown by the Driver Power vs. Dependence quadrant diagram created through the Interpretive Structural Modelling (ISM) approach.

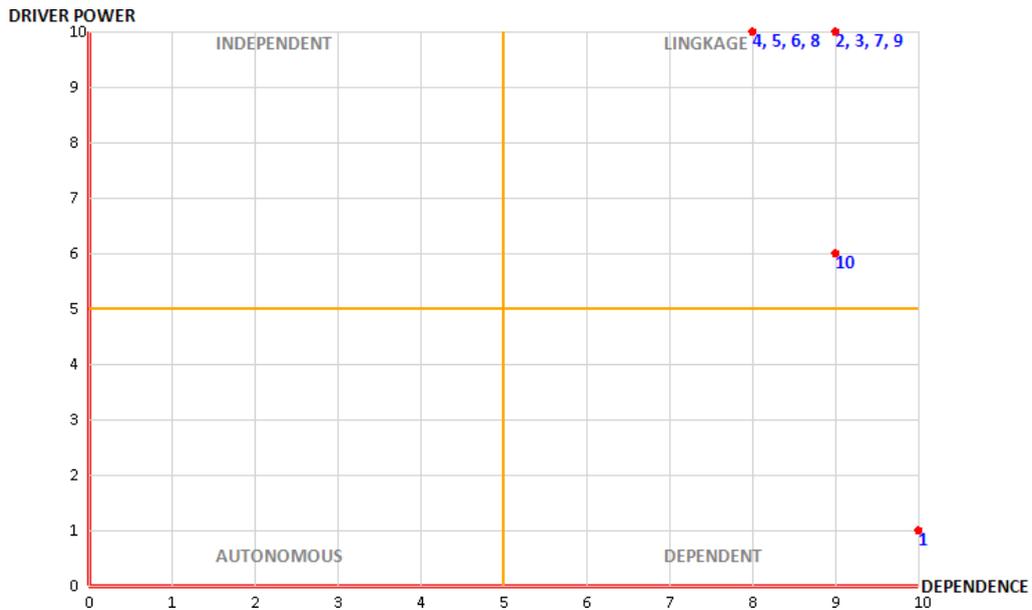


Figure 2. MICMAC Analysis of the Creative Economy Development Collaboration Model between ZI and Islamic Microfinance Institutions

Quadrant I (Autonomous)

This quadrant has no variables. This shows that no variable in the study is autonomous or isolated; rather, every variable has an impact on or dependency on the system.

Quadrant II (Dependent Variables)

Only variable 1 falls into the dependent category. This position is characterized by high dependence but weak driving power. It indicates that government policies and regulations are more likely to be influenced by other variables rather than acting as primary drivers. In other words, new regulations generally emerge as a response to dynamics in the field, such as the financing needs of MSMEs, collaboration patterns between ZIs and SMIs, or innovations in the creative economy sector. This condition implies that regulations cannot function as driving factors on their own. However, when supported by linkage factors and other relevant elements, government policies can serve as crucial instruments that provide legitimacy and clear direction for the sustainability of collaboration.

Quadrant III (Linkage Variables)

The majority of the variables factors 2, 3, 4, 5, 6, 7, 8, 9, and 10 are located in this quadrant, indicating that they both significantly influence and are significantly influenced by other variables. Due to their ability to act as a link between different components of the cooperation system, they are in a highly strategic position.

The characteristics that determine the success of collaboration among Zakat Institutions (ZIs), Islamic Microfinance Institutions (SMIs), and creative Micro, Small, and Medium Enterprises (MSMEs) are crucial. These variables include Government Policies & Regulations, Access to Finance, Infrastructure and Technology, Human Resources & Training, Networks and Partnerships, Marketing and Market Access, Community and Social Support, Innovation and Adaptation, Logistics Infrastructure, and Geographical Environmental Change.

Quadrant IV (*Independent Variables*)

No variables were found in the independent quadrant of this study. The absence of factors in this category indicates that all identified variables are closely interconnected with others, either as drivers or as elements being influenced. This result highlights the importance of a collaborative approach, in which no single factor can operate in isolation. Such a pattern illustrates that the success of collaboration among ZIs, SMIs, and MSMEs can only be achieved through the integration of roles rather than through isolated efforts.

This research aims to analyze the collaboration between the Zakat Management Institution (ZI) and the Islamic Microfinance Institution (SMI) in supporting the development of the creative economy through the application of Interpretive Structural Modeling. (ISM). The analysis indicates that most of the research factors are concentrated in quadrant III (linkage), meaning that these variables possess both high influence and high dependence. This position emphasizes that the success of collaboration among ZIs, SMIs, and MSMEs is largely determined by the management of linkage factors, which are both strategic and sensitive in nature. In this discussion, we will relate the main findings to the relevant literature to enrich the understanding of the existing dynamics.

The results indicate that government policies and regulations function more as dependent factors, emerging as a response to other dynamics within the collaboration among ZIs, SMIs, and MSMEs. Although not primary driving elements, such regulations remain important as they provide legitimacy and direction that strengthen the effectiveness of the partnership. Policies that are supportive can guarantee the protection of micro, small, and medium-sized firms (MSMEs) in the creative sector and offer incentives for the expansion of the creative economy. Government policies that promote the creative economy are crucial, according to [Rosyadi et al. \(2022\)](#), particularly when it comes to giving entrepreneurs access to capital, mentorship, and training. In the absence of well-defined regulations, Indonesia's creative economy will struggle to grow. In order to link different sectors, including the private sector, financial institutions, and non-governmental groups like ZI, the government must actively participate in the creation of a favorable ecosystem.

Additionally, studies conducted by [Gupta & Matharu \(2022\)](#) demonstrate the critical role played by fiscal and non-fiscal government policies, including the provision of subsidies, tax breaks for MSMEs, and infrastructure development that fosters the expansion of the creative economy. Good rules will allow for creativity and innovation, especially for MSME players who frequently encounter resource constraints and bureaucratic roadblocks. This study also indicated that one important factor in fostering creative MSME actors is access to finance from ZI and SMI. For micro-entrepreneurs who might find it challenging to obtain funding from traditional banking institutions, the partnership between ZI and SMI in offering Sharia-based financing offers a more welcoming and inclusive financing strategy.

Funding for microbusinesses through zakat, infaq, sadaqah, and other social subsidies is strategically supported by the Zakat Institution (ZI). [Najmudin et al. \(2022\)](#) assert that utilizing productive zakat by providing funding to MSMEs operating in the creative economy will enhance the well-being of mustahik (zakat recipients) and motivate them to grow more self-sufficient. Furthermore, as [Wu & Xiao \(2020\)](#) notes, working with SMI improves MSMEs' capacity to handle their finances by utilizing sharia financing schemes that are founded on the values of fairness and transparency.

The investigation also discovered a disconnect between the needs of MSME operators and the available access to funding, despite the fact that ZI and SMI's relationship has been working well. Many innovative MSMEs still struggle to get funding, mostly as a result of the business players' poor managerial skills and lack of knowledge.

The study's findings emphasize the significance of supplying technology and infrastructure to innovative MSME players. Innovation in product development and marketing is made possible by technology, which also helps to improve operational efficiency. It has been demonstrated in a study by Adiningsih et al. (2024) that technical infrastructure, particularly internet connectivity and e-commerce, speeds up the expansion of innovative MSMEs in Indonesia. The adoption of digital technology by MSMEs also enables them to reach a wider audience and provide their goods internationally. But the issue that inventive MSMEs in Indonesia frequently deal with is the lack of access to contemporary technologies.

In their operations and marketing, a lot of business owners still use traditional techniques. Furthermore, it is crucial to have a sufficient supporting infrastructure for things like transportation, roadways, and logistics. One of the primary barriers to the growth of creative SMEs, according to Rijal et al. (2023), is inequalities in rural infrastructure. Therefore, the government and other relevant parties must continue to support investment in the development of physical and digital infrastructure.

The success of the partnership between ZI, SMI, and innovative SMEs is significantly influenced by the development of human resource capacity through training. Entrepreneurs may increase their competitiveness in highly dynamic areas like the creative economy by investing in training and skill development. Radicic & Petković (2023) assert that in order to support creative SMEs in adapting to market shifts, training initiatives emphasizing the development of management abilities, digital marketing strategies, and product innovation are essential. One of the problems this study found is that many MSME players have poor levels of formal education, which prevents them from taking full advantage of business prospects.

Enabling MSME actors to be more autonomous and creative might help them get over these obstacles with the right training. Sutrisno et al. (2023) and Kwartawaty et al. (2023) further highlights how crucial it is to provide community-based training that includes MSME players directly in the educational process. So that the outcomes are more applicable, a successful training program needs to be customized to the unique requirements of each creative business community.

Collaboration between ZI, SMI, and innovative SMEs has been shown to be significantly enhanced by network and partnership characteristics. With a robust network, entrepreneurs may access more markets, resources, and business partners to help their companies flourish.

The success of growing the creative economy, according to Gumel & Bardai (2023), depends on strategic alliances between SMEs, the government, financial institutions, and other organizations. Through this alliance, creative MSMEs may now more easily access markets, technology, and knowledge. This study also emphasizes how business actors working together in creative communities can foster cooperative innovation and raise the level of competitiveness of locally produced goods.

However, there are still challenges in building a strong network, especially for MSMEs located in remote areas. Yoshino (2016) notes that geographical isolation and lack of logistical support make SMEs in the region less connected to larger markets. Therefore, further efforts are needed to build a more inclusive network and encourage cross-sector collaboration. Innovation and adaptation are essential elements in the sustainability of creative endeavors. In an ever-evolving industry, the ability to innovate and adapt to changes is key to remaining relevant and competitive. This research shows that creative SMEs capable of innovating, whether in terms of products, processes, or business models, have a greater opportunity to grow and develop.

Yoshino (2016) highlights that innovation includes elements of marketing, product design, and distribution strategies in addition to its connection to technology. Profitable SMEs typically have the ability to recognize market changes and modify their offerings to meet customer needs. In the meantime, Yoshino (2016) noted that in order to guarantee that MSMEs can endure in the face of global problems, adaptation to environmental changes, such as climatic and geographical changes, is also crucial.

A number of elements, particularly in terms of the acceptance of locally produced goods, are what propel the growth of the creative economy, including social and community support. Creative enterprises can be significantly encouraged to remain sustainable by the community's involvement in supporting local MSME products. Research by Yoshino (2016) notes that social awareness efforts to promote locally produced goods have been shown to boost interest in creative products among consumers through social media and community

involvement. This campaign's target audience favors local MSME actors over imported ones and has a tendency to support them more.

5. Conclusion and Recommendation

The results and discussions demonstrate that collaboration among ZIs, SMIs, and MSMEs holds significant potential to foster the expansion of Indonesia's creative economy. The ISM–MICMAC analysis further shows that most of the key variables influencing the system fall into the linkage category, including Access to Finance, Infrastructure and Technology, Human Resources & Training, Networks and Partnerships, Marketing and Market Access, Community and Social Support, Innovation and Adaptation, Logistics Infrastructure, and Geographical Environmental Change. This position underscores that the success of the partnership cannot be driven by a single factor alone but rather requires strong interactions among multiple elements.

Based on these findings, the proposed collaboration model can be illustrated as follows:

1. ZIs (Zakat Institutions) act as providers of productive social funds through zakat, infaq, and sadaqah. These resources can be directed to strengthen the initial capital of creative MSMEs, particularly those that are not yet bankable, as well as to support community-based empowerment programs.
2. SMIs (Islamic Microfinance Institutions) function as financial intermediaries by channeling Islamic financing, providing financial literacy, and assisting MSMEs in business management. SMIs can also serve as a bridge for distributing social funds from ZIs to ensure their effective and sustainable utilization.
3. MSMEs (creative Micro, Small, and Medium Enterprises) serve as the primary actors who transform financial and social support into productive activities, product innovation, and market expansion. The ability of MSMEs to generate added value becomes a tangible indicator of the effectiveness of collaboration.

Through this model, collaboration can be understood as a circulation of value: ZIs provide social resources, SMIs manage and distribute them in the form of productive financing, and MSMEs optimize this support to generate economic growth. The three sectors are mutually dependent within a single system, where the success of one strengthens the sustainability of the others.

A comprehensive and inclusive strategy encompassing all pertinent parties, such as the government, financial institutions, local communities, and the practitioners of the creative industry themselves, must be employed to continue promoting this collaboration in order to achieve more profound results. So that innovative MSMEs in Indonesia can grow sustainably and make a greater economic contribution to the country, appropriate legislation, easily available financial support, sufficient infrastructure, and strengthened collaboration networks must be created further.

In general, this study offers a comprehensive summary of the dynamics of cooperation amongst Islamic Microfinance Institutions (SMI), Zakat Management Institutions (ZI), and creative MSME actors in fostering the growth of Indonesia's creative sector. We were able to uncover important elements that contribute to this collaboration's success through the use of Interpretive Structural Modeling (ISM), including government regulations, financial availability, infrastructure, innovation, and social support.

This study also demonstrates that a number of issues still need to be resolved, particularly those related to infrastructure deficiencies, inadequate financial literacy among MSME operators, and funding accessibility. Therefore, in order to address these issues, more organized and methodical efforts including all pertinent stakeholders in the creative economy ecosystem are required.

One way to address socioeconomic problems in Indonesia is likely to be closer cooperation between ZI, SMI, and creative MSMEs; this is especially true when it comes to using the creative economy to empower communities and reduce poverty. It is envisaged that in the future, the cooperation of zakat organizations,

Islamic financial institutions, and innovative business owners will grow and make a substantial contribution to the inclusive and long-term growth of the national economy.

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Know Your Customer (KYC) Credit Risk Assessment: A Study of the PBZ Ikhlas – Zanzibar

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Abstract

Risk cannot be avoided completely but its effect could be reduced where there is understanding on types of risks involved and setting mitigation measures. In financial institutions such as banks, the most common risk factor is Know Your Customer (KYC). How much information does the financial institution possess regarding new customers; what changes have occurred on existing customers. This study aims to find out what are the risk factors that cause the People's Bank of Zanzibar (PBZ) Ikhlas branches to have Non-Performing Finance (NPF), in particular the KYC factor. The 5Cs – Character, Capacity, Collateral, Capital and Conditions – principle are applied, which are intended not to harm debtors who later commit defaults, such as NPF. This is a survey study of PBZ Bank Ikhlas for 2022 operations only and it involves data collection mainly from available reports. The survey was conducted through consultative meetings and by use of questionnaire covering ten officers at PBZ including Shariah Advisory Committee (SAC) and the management members. Data was subjected to a qualitative analysis delving into non-numerical data, open-ended responses and deeper insights. Though this study does not aim to bring about changes in running PBZ, the findings and suggestions could help in understanding the challenges and mitigate the risks. The findings show that there is most likely a lack of an in-depth due diligence on KYC and regular training to both SAC and the PBZ Bank Ikhlas (PBZ) staff. In order to reduce credit risk at PBZ and hence move forward financial stability, PBZ is advised to consider customer background while assessing character. The 5Cs should be made a priority in appraising customers and most importantly engage customers with transparency about the PBZ Ikhlas services and conditionality.

Keywords: Zanzibar, Credit Risk, Know Your Customer, Non-Performing Finance, PBZ, Ikhlas.

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1. Introduction

The People's Bank of Zanzibar (PBZ Bank) was established in 1966 by the [Companies Decree Cap.153 \(1953\)](#) and it is a public trust with 100 percent shares by the Government of Zanzibar. Primarily, it was intended to become the Bank of Zanzibar with powers like any other central bank. However, being part of the United of Republic of Tanzania where fiscal policy is a union matter as per the first schedule of article 4 of the [Constitution of the United Republic of Tanzania \(1977\)](#), such ambitious expectations could not materialise.

PBZ Bank continued to offer services as Commercial Bank but it was the custodian of Zanzibar Government finances, both local and foreign currencies. In the period from 1966 to late 90s' there were only two banks operating in Zanzibar: PBZ Bank and the National Bank of Commerce (NBC) where Zanzibar Government has shares. The Central of Bank of Tanzania (BOT) has its branch in Zanzibar providing fiscal and other services. From early 2000s' Zanzibar Government was compelled to open accounts with BOT and

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hence PBZ Bank has no monopoly of Government funds. It is this case that led PBZ to diversify its business plan to include more products.

Zanzibar is predominantly a Muslim majority society where a call for halal products particularly at the PBZ Bank has been raised. In response, in 2000 PBZ Bank began preparations to introduce Islamic Banking but there was no legal and regulatory framework at the Bank of Tanzania (BOT). In 2012, PBZ Bank was granted license to operate Islamic Banking Division (Islamic Bank window-PBZ Bank Ikhlas) with expertise from Malaysia and Qatar. Subsequently a Shariah Advisory Committee (SAC) was established. The SAC has been functioning since the Islamic Window started full operation in 2012. The first SAC started immediately after launching Islamic Window while the second came in office in 2021. The Chairperson ended terms of office and the Deputy Chairperson took over the chairmanship; hence only two chairpersons have exchanged offices since its establishment. This arrangement has ensured continuity and maintains stability in Ikhlas operations.

This measure attracted more customers and in the 10 years period since the introduction of Islamic Division - Window (2012 – 2022), the Bank expanded its operations beyond Zanzibar. It has 8 branches and 3 service centers in Zanzibar and Tanzania Mainland (PBZ Finance Report, June 2022). Plans are underway to open more branches and service centers in Tanzania Mainland. Definitely, with shortage of local expertise in the Islamic Finance and Banking, the easiest business in a bank is financial services in the form of credit. However, this must be in accordance with Islamic Finance Standards Board (IFSB) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) aiming at achieving Shariah principles including Islamic values with other requirements. Other actions introduced by banking regulators is Know Your Customer – KYC principle.

This study examines how much “Know Your Customer – KYC” contributes to credit risk and what should be done in reducing risks in the banking business, challenges experienced and mitigation measures undertaken by the management. This study will examine the role of Shariah Advisory Committee (SAC) in minimising risks and measures to overcome such risks. In the end, suggestions will be given to cut down credit risk at PBZ Bank Ikhlas.

Know Your Customer – KYC practices in Islamic banks are particularly crucial given the growth of online transactions and associated fraud risks (Miskun et al., 2023). While these banks follow similar regulatory standards as conventional banks, they also align their practices with Shariah principles (Manan and Yusoff, 2024). This study explores the intersection between Know Your Customer (KYC) processes and credit risk management within the PBZ Bank Ikhlas of Zanzibar.

KYC is traditionally associated with regulatory compliance and anti-money laundering (AML). It plays an increasingly critical role in assessing and managing credit risk (Utami & Septivani, 2022; Isima & Khoirunnisa, 2023). By examining customer identification, verification, and profiling procedures, a robust KYC framework not only helps banking institutions comply with legal obligations but also provides valuable insights into the creditworthiness and risk profile of clients (Fitriyani, 2021 in Miskun et al., 2023). This study delves into how enhanced due diligence can uncover red flags, such as inconsistent income sources or suspicious transactions, that may indicate potential default risks.

Non-Performing Finance (NPF) reflect bad debts that can hurt profitability and slow economic growth. Islamic banks attempt to prevent NPFs through the KYC standards (Priyadi et al., 2021). Other methods to resolve NPFs include rescheduling, reconditioning, and restructuring (Indah Putri et al., 2024). Despite operating under Shariah-compliant principles, Islamic banks can experience higher credit risk due to the absence of tailored risk management tools, underscoring the need for more effective regulations and financial innovations to support their growth and stability (Haddad and Souissi, 2022).

This study is intended to examine how much KYC contributes in reducing risks at PBZ Bank IKHLAS. Secondly the findings will enrich the authors in the aspects of Risk Assessment and Mitigation while at the same time officers at PBZ Bank might use these findings to conduct detailed risk assessment studies in other operation areas.

This study is divided into seven sections: (i) Introduction, (ii) Objective of the study, (iii) Literature review, (iv) Research methodology, (v) PBZ Islamic Banking Window (Ikhlas) and business coverage, (vi) Data and analysis of the findings, and (vii) Conclusion and suggestions on mitigations measures against credit risk.

2. Literature Review

The current study aimed to identify the contribution of the “Know Your Customer” (KYC) principle to credit risk in minimising risks in the banking industry, challenges it faces and important measures to be taken by the management. The literature review focuses on exploring studies specifically related to credit risk, Non-Performing Financing and KYC. There has been growing recognition of the credit risk and how it relates to the NPF, relatively on the Islamic banking sector. The subsequent sections outline the arguments that form the basis for developing the study’s keywords.

2.1. Know-Your Customer (KYC)

The banking world recognises the principle of “Know Your Customer” (KYC) which is one of the most important principles in the world of banking and finance. This principle refers to the policies and procedures implemented by financial institutions to ensure the correct identity and characteristics of their customers before offering financial services to them. By ensuring that each customer has gone through a proper identity verification process, financial institutions can build a good image and increase public trust in their financial services (Miskun et al., 2023).

Financial institutions must ensure that the KYC system implemented complies with applicable regulations and is able to detect potential risks and take the necessary precautions to combat these risks (Iryana et al., 2017). This Know Your Customer principle allows banks to find out details about bank customers. The bank is given the power to decide whether the customer intends to enter into a legal relationship with the bank’s qualities and trust. Banks are therefore entitled to obtain information so that they can obtain an overview of their customers, monitor customer transactions and suspicious activity can be reported immediately (Miskun et al., 2023).

The application of the 5Cs principle is introduced so that the bank is not harmed by debtors who later commit defaults, such as Non-Performing Finance (Miskun et al., 2023). The commonly referred to as the 5Cs include: Character, Capacity, Collateral, Capital and Conditions (Sulistiyandari et al., 2024). The 5Cs provide understanding and awareness that the financing contract is a debt contract. For Islamic banks, the 5Cs exist in debt and receivable contracts as written in the Qur’an (Al-Baqarah, 2:280-283), which state that debts must be acknowledged, well written and must also be repaid except in certain emergency conditions (Indah Putri et al., 2024).

2.2. KYC in Islamic Banks

As banking operations heavily depend on internet and digital transactions, rampant banking crimes such as data theft and online fraud are escalating (Miskun et al., 2023). In order to address unfavourable credit levels and less stringent banking supervision, banking regulators continue to improve banking supervision and regulation to provide better protection to customers through Know Your Customer – KYC (Munni, 2024; Miskun et al., 2023).

Customers are required to fill the KYC application and this forms as an integral part of the Islamic banks information hub (Hossain, 2022). KYC assist, among others, to strengthen Islamic bank’s corporate social responsibility as the bank will incorporate social and environmental concerns into their business operations and interactions with their customers (Hossain, 2022). However, barriers to implementation are detected including customer dishonesty in providing information to the bank (Isima & Khoirunnisa, 2023).

The principle objective of KYC is to protect banking and financial institutions (including Islamic one’s) from the risks of fraud or terrorist financing (Miskun et al., 2023; Rahmiyati & Rimayanti, 2024). When applied to anti-money laundering, Islamic banks tend to modernise Know Your Customer (KYC) processes and improve risk mitigation and support outdated information technology systems (Utami & Septivani, 2022). In some other instances, the Know Your Customer (KYC) platform is based on blockchains which is built from mobile application and completed through deployment and testing (Minaz et al., 2023).

KYC is applied by both, in the conventional and Islamic banks. The Islamic banking sector is subjected to strict supervision to combat financial crime, just like conventional banks (Utami & Septivani, 2022; Isima & Khoirunnisa, 2023). All banks, whether conventional or Islamic, must comply and implement information disclosure clauses, and example anti-money laundering standards, such as the KYC (Utami & Septivani, 2022; Isima & Khoirunnisa, 2023).

2.3. Implementation of the KYC

The provisions of the *Banking and Financial Institutions Act (2006)* of Tanzania encompass the prudential principle in business activities related to fundraising. For instance, *Anti-Money Laundering Regulations (2022)*

addresses the implementation of Anti-Money Laundering (AML) and Prevention of Terrorism Financing (PPT) programs in the financial services sector. The anti-money laundering program is provided under regulations 8, 10 and 16 of the Anti-Money Laundering Regulations 2022. The implementation begins with the preparation of guidelines and standard practices for implementing Know Your Customer principles which are a prerequisite for Islamic banks to support the program (Sulistiyandari et al., 2024).

The guidelines stipulated by the Regulations in the application of Know Your Customer Principles cover at least the principles of acceptance and identification of prospective customers, practices for controlling customer accounts and transactions, and risk management practices (Fitriyani, 2021 in Miskun et al., 2023). These Regulations also require banks to obtain comprehensive information about customer identities, monitor transaction activities, and report any suspicious transactions. The goal is to better understand customer profiles, transactions, and business activities (Miskun et al., 2023; Sulistiyandari et al., 2024).

In practice, there have been violations of the prudential principle in Tanzanian banking activities that have led to banking crimes. This study indicates that violations stem from the failure of banks (and their managers) to conduct 5Cs analysis (Character, Capacity, Collateral, Capital and Conditions) for prospective customers. Instances of non-compliance include failure to conduct proper customer due diligence and file suspicious transaction reports to the Financial Intelligence Unit (FIU) (Bank of Tanzania, 2019; Sulistiyandari et al., 2024).

2.4. Credit Risk

Credit risk is the probability that a bank trading partner, borrower or partner, will fail in meeting his financial obligations as agreed with the bank (Jimoh et al., 2022; Scott et al., 2024; Budiarto, 2023; Manan and Yusoff 2024). Credit risks can also be defined as: “the change in the net value of assets due to the expected debtor’s ability to fulfill their contractual obligations to the lender in a timely manner” (Bahat and Darzi, 2019 in Abumatar, 2024).

Banks encounter credit risks in almost all of their operations because their relationship with customers is essentially a fiduciary or debtor-creditor relationship (Abumatar, 2024). Credit risks are considered as the most dangerous risks faced by financial institutions (Hussain and Al-Ajmi, 2012 in Jaelani et al., 2024). The higher the credit risk, the worse the bank performance (Manan and Yusoff, 2024). Factors contributing to credit risk include borrower credit worthiness, financial crisis or in economic downturn, industry trends, and regulatory environment (Scott et al., 2024; Abumatar 2024; Razif, 2015). Credit risk can also originate from business activities, such as acceptances, interbank transactions, lending, trade financing transactions, commitments and contingencies, bonds and exchange rates, and derivative transactions (Hassan et al., 2019 in Budiarto, 2023).

2.5. Credit Risk in Islamic Banks

As conventional banks are bigger in sizes and have stronger portfolio diversification, credit risk in Islamic banks are sophisticated (Manan and Yusoff, 2024; Marnouch and El Khamlichi, 2024; Chowdhury et al., 2023). However, in Bahrain the risk is rather lower due to resilient regulatory frameworks and devotion to Shariah standards (Manan and Yusoff, 2024). Credit risk and income diversification are the most common factors associated with Islamic bank insolvency (Marnouch and El Khamlichi, 2024; Abumatar 2024).

2.6. Credit Risk in Selected Islamic Bank Products

Credit risk comes in different forms in Islamic banks depending on the types of financial contracts. As Islamic banks provide different financial products, this section will examine on four basic services: murabahah, musharakah, istisna and ijarah.

Murabahah is a transaction by which the trader (Islamic Banks) buys a property for the purpose of selling it to the buyer on an agreed profit ratio plus cost (Van Greuning and Iqbal, 2008). In murabahah transactions, Islamic banks are exposed to credit risks when the bank delivers the asset to the client but does not receive payment from the client in time. In case of a nonbinding murabahah, where the client has the right to refuse delivery of the product purchased by the bank, the bank is further exposed to price and market risks (Van Greuning and Iqbal, 2008; Alkhawaja and Görmüş, 2019; Ijaiya et al., 2021).

The primary source of the risk is the murabahah financing, which represents the most significant portion of Islamic banking financing transactions (Adewale and Elena, 2019 in Ijaiya et al., 2021). This is due to the nature of Islamic banking in general and the nature of financing in particular, in which mark-up is added to the cost of financing depending on the risk associated with the transaction (Ijaiya et al., 2021). Murabahah financing represents the most significant portion of Islamic banking financing transaction.

Musharakah is defined as a profit-loss based on joint project or an enterprise in which partners share profit or loss according to predetermined ratio (Bhatti, 2011 in Alkhawaja and Görmüş, 2019). Credit risk in musharakah agreements come to existence as a result when the partner does not pay the profit shares to the bank or when the business outcomes vary from the banks expectations (Akkizidis and Kumar, 2008 in Alkhawaja and Görmüş, 2019).

Istisna is a contract made with a producer or a labour to create a good based on specific standards, some percentage of the payment can be advanced (Borhan, 2002). Credit risk occurs in istisna when a customer fails to make payment due for the manufactured goods as agreed. Credit risk can also arise as a result of the buyer incapacity to buy the agreed product or providing the installed payments after receiving the product (Akkizidis and Kumar, 2008 in Alkhawaja and Görmüş, 2019). As for ijarah contract, the lessor (the owner) gives the right to lease a specific property or a good for a fixed period of time against an agreed amount of money (Fatima, 2006). Credit risk arises in case the customer could not fulfil paying the agreed money to the bank (Vejjagic, 2014 in Alkhawaja and Görmüş, 2019).

2.7. Credit Risk and Islamic Banks in Africa

Islamic banks in Africa are characterised with technical inefficiencies and low efficiency linked to high exposure to different risk variables such as credit, liquidity and operational risks (Ijaiya et al., 2021). Other reasons include lack of valuable securities to be presented as collateral for bank lending, absence of good titles to properties, lack of presentable business plans, and lack of proper financial documentation (Ijaiya et al., 2021). The issue of regulation and compliance is another challenge for Islamic banks in Africa. According to Ariffin and Tafri (2014), some banks have some abstruse fees, which may be perceived as interests designed in the form of management fees which cumulate to the high cost of accessing financing of Islamic banks and eventual default in repayment (Ijaiya et al., 2021).

2.8. Credit Risk Management in Islamic Banks

Management of credit risk in Islamic banking can be worth referenced according to Islamic Financial Services Board (IFSB) which supplies strategies and known factors causing it (Kusnandar, 2022). The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. In order to have in place sound processes of credit risk management, the IFSB 2005 provides the following recommendations that Islamic banks must have:

- (a) an appropriate credit strategy, including pricing and tolerance for undertaking various credit risks;
- (b) a risk management structure with effective oversight of credit risk management;
- (c) credit policies and operational procedures including credit criteria and credit review processes, acceptable forms of risk mitigation, and limit setting;
- (d) an appropriate measurement and careful analysis of exposures, including market- and liquidity-sensitive exposures; and
- (e) a system (i) to monitor the condition of ongoing individual credits to ensure the financings are made in accordance with the IIFSs' policies and procedures, (ii) to manage problem credit situations according to an established remedial process; and (iii) to ensure adequate provisions are allocated.

In relation to Tanzania's banking regulatory framework, *Management of Risk Assets Regulations (2014)* were made under section 71 of the Banking and Financial Institutions Act 2006 for the purpose of ensuring that, banks and financial institutions including Islamic banks and Islamic financial institutions have adequate credit and investment policies. These rules are meant to identify, measure, monitor and manage the risk arising from financial businesses to ensure timely and adequate actions are taken on problem assets, maintain risk management standards that conform to the established international norms and promote and maintain public confidence in the banking sector (Suddy, 2021).

Although these Regulations provide a proper way through which management of risk assets will be conducted well, they fail to take into consideration the uniqueness of Islamic banks. Therefore, in order to allow Islamic banks to undergo management of risk assets, the government through the Minister responsible for Finance has to come up with regulations that will address the unique features of Islamic banking (Suddy, 2021).

A study by Haddad and Souissi (2022) probed into the impact of risk management practices on the effectiveness of Islamic banks in the United Arab Emirates (UAE). The researchers observed a noteworthy positive influence of risk management practices on the profitability of Islamic banks. This underscores the importance of integrating effective risk management measures to sustain profitability in the context of Islamic banking (Ismail, 2023). With the principles of risk-sharing and ethical finance inherent in Islamic banking, adopting robust risk management practices becomes particularly significant to safeguard stakeholders' interests and uphold the principles of Shariah. The study's findings suggest that Islamic banks should prioritise the implementation of sound risk management strategies to optimize their profitability and financial sustainability (Haddad and Souissi, 2022 in Ismail, 2023).

2.9. Non-Performing Finance (NPF)

Credit risk in Islamic banks is in the form of financing risk, namely Non-Performing Finance (NPF) which is influenced by the client's age, gender, occupation and type of contract (Muhammad et al., 2020 in Hernawati et al., 2021). Non-performing financing (NPF) is the term used in Islamic banking that refers to a bank loan that has been defaulted on or is unlikely to be paid back in full by the borrower. In conventional banking, it is known as a non-performing loan (NPL).

Non-Performing Finance (NPF) represents a tool to measure financing risks. Banking performance can be evaluated by measuring the level of NPF to indicate liquidity, profitability and solvability ratios (Dwiandayani, 2017). Isaev and Masih (2017) maintain that NPF plays a key role in determining the quality and performance of banks because financing is the main function of banks in contributing to economic development. NPF are also a key concern for the banking industry since they lower bank profitability and are sometimes seen as preventing banks from lending more to businesses and individuals which in turn will slow down economic growth (Kumar et al., 2018 in Hernawati et al., 2021).

NPF in Islamic banking is one of the risk measurements for bad credit (Faiz, 2010). Hence, Islamic banks need to specifically manage their NPF level because it will have an impact on their performance in competing with conventional banks (Nugraheni and Muhammad, 2019 in Priyadi et al., 2021; Indah Putri et al., 2024). To resolve NPF in Islamic banks, four procedures can be applied when the bank faces financial problems: rescheduling, reconditioning, restructuring and confiscation of collateral. However, in practice, Islamic banks often opt for rescheduling and reconditioning to resolve Non-Performing Financing. If the conditions turned difficult to repay the debt, the customer will be released. Moreover, by recording the receivables, they will be written off (Indah Putri et al., 2024).

Bad credit is a parameter of sluggishness in the real sector in response to broader economic conditions so that the banking sector is often affected and falls into crisis conditions. Despite the fact that Islamic banking has a unique system and application of Shariah principles, it is assumed that Islamic banking also carries a high risk. When compared to conventional banking, Islamic banking has a greater credit risk due to the lack of proper management instruments in managing risk (Effendi and Yuniarti, 2018). Even after the late 1990s monetary crisis, conventional banking's NPL level continued to fall, indicating an improved condition, whereas Islamic banking's NPF level remained stable on a range of 2 to 4% (Iqbal, 2017 in Kusnandar, 2022; Chowdhury et al., 2023).

3. Research Methodology

The methodology used in writing this study is the survey of PBZ Bank Ikhlas for 2022 operations only. The survey involves questionnaires distributed to participants as well as data collection mainly from literatures and available reports, discussion with two officers responsible with Shariah Compliance and authors' own experience at the Bank. No other companies are involved. The scope is therefore very narrow as the study is not intended to bring about changes in running PBZ Bank Ikhlas. However, the findings could help in understanding the challenges and hence move forward with a broader research into the area of risk assessment and mitigation. The survey was conducted by use of questionnaire covering the two areas that is Credit Risk related to KYC and Credit Risk related to Islamic Financial Transactions. Ten officers at PBZ Bank Ikhlas including SAC members and management were randomly selected to respond to the questionnaire. It is worth noting that author 1 of this study is the Chairman of Shariah Advisory Committee of PBZ Bank Ikhlas. Hence, he is obliged by Regulations not to disseminate confidential information. In this case, care has been taken to inform the public on factors that are general and useful for researchers.

4. PBZ Islamic Banking Window (Ikhlas) and Business Coverage

PBZ Ikhlas is a division which follows Shariah in its transactions and it has Shariah Advisory Committee (SAC) operating with the support of Shariah Compliance Manager (SCM). In its day-to-day operations, PBZ Bank conventional service centers also serve PBZ Ikhlas customers. It is not certain how much this arrangement could result into Shariah Non-Compliance Risk (SNCR). This aspect needs a detailed study.

PBZ Bank has formally defined relationships between its management, its Board of Directors, its Shariah Compliance Committee and its shareholders which is the Government of Zanzibar through the Treasury Registrar. In this way, PBZ Bank has a corporate structure as well as a culture through which its objectives and monitoring performance are determined. It is this corporate structure which provides trust to customers, shareholders and other stakeholders. The Executive Director of PBZ Bank is appointed by the President of Zanzibar as well as the Chairman of the Board of Directors. However, the Chairman of SAC is appointed by the Minister responsible for Finance while members of SAC are appointed by the Board. The Board and Management make sure that if one person sits in another Bank's SAC, such a person cannot be appointed at PBZ Ikhlas at the same time. In this way conflict of interest is eliminated, Shariah Governance Framework (SGF) is observed and hence limiting risks.

Islamic Banking Division collects its revenue from different Shariah compliant sources of income; these include profit from Islamic financing, bank commission and gain on foreign exchange. Table 1 provides a summary of banking operations in 2022. Cash from all Islamic branches was TZS 6,940 million which is an increase of 30.43% compared to TZS 5,321 million recorded in the previous period (1 USD = 2,567 Tanzania Shillings (TZS) as of July 24th, 2025). It is reported that PBZ Ikhlas has accumulated un-invested funds; in 2022 such amount was reduced from TZS 120 billion to TZS 106 billion; a decline by 11.75%.

In 2022, PBZ Islamic began to enter into a new area of business that is Islamic Bond (sukuk). There was one investment of this type to the tune of TZS 500 million from a microfinance organization with tenure of one year with profit rate of 7% and expected to mature in August 2022. In this sukuk while the returns are lucrative, there could be Shariah Non-Compliance Risk, not necessary credit risk because aspects of KYC were loosely analysed. This is not the scope of this study and this aspect will not be covered in this study.

The PBZ Bank Ikhlas Quarterly Report of June 2022 explains the amount of un-invested cash (UIC) in Islamic division which can effectively be utilised for the production of revenue in various Shariah compliance investments. The Report shows that the amount of UIC cash was reduced by 11.79% which indicates a diversified approach in business financing (e.g. murabahah, istisnaa, tawarruq, salaam and sukuk of the late). Since all these financing at the end imply funding of business activities, there is a likelihood of Non-Performing Finance which is a credit risk.

In June 2022, the total financing portfolio stood at TZS 68,120 million compared to TZS 68,619 million reported in the quarter ended March, 2022 recording a decrease of 0.73% of the general financing portfolio. The decrease was contributed by written off of Non-Performing Financing during the quarter amounting TZS 2,472 million. It was observed that this act of writing off non-performing financing is mostly the result of credit risk.

The following is an analysis of the PBZ credit risk and its link with: (i) Know Your Customer (KYC) and (ii) Islamic Financial Transactions:

4.1. Know Your Customers from the point of Credit Risk

Credit risk, which is also called counter-part risk, is a situation whereby Islamic financial institution enters into an agreement with a customer and the customer fails to meet the payment obligations (Abumatar, 2024). Normally a bank should know the customer very well before entering into such agreements (this is called Know Your Customer – KYC). When a bank enters into such agreements the principle motive is to realise profits and in this regard the bank is investing (Alkhawaja and Görmüş, 2019). Under a normal situation, an investor will not surrender their money if the project or the activity is not secured since this could lead to high risk; this also applies to Islamic Financial Institutions. Save with slight discussion on anti-money laundering activities in relation to KYC, this study does not deal in detail with issues of terrorism and illegal businesses. It is the Shariah compliant businesses that are of interest since customers may have different Non-Shariah Compliant Risk motives from the beginning even when the products or activities are acceptable.

KYC does not only refer to knowledge of customers from available documents, but such information should be analysed on quality assurance perspective. It is essential to obtain information on the type of business

involved and to examine the customer’s business history, including their banking relationships. Originality of customers such as where they come from, their residence and association with politicians could also indicate their reliability in repayment and conducting proper business. Some countries or some geographical location has prevalence of risk and hence more care is needed (Indah Putri et al., 2024).

4.2. Islamic Financing Transactions Financing (Portfolio Composition and Performance)

At PBZ Bank Ikhlas Financing Portfolio in 2022 stood at TZS 68.12 billion showing a slight decrease of 0.73% in comparison to TZS 68.618 million recorded in the three months period in the same year. Cumulative total disbursement as at 30th June 2022 was TZS 14.33 billion equivalent to 100.96%, achievement of the cumulative budget of TZS 14.20 billion. The main financing transactions for the portfolio during this period are illustrated in Table 1 below.

Table 1: Disbursements under Islamic Financial Transactions

S/No.	Islamic Financial Transactions	Explanation of Disbursements
1.	Mudharabah	Individual Financing disbursement was TZS 12.34 billion compared to budgeted amount of TZS 8.37 billion as at 30 th June, 2022. This is 147.43% against the budgeted amount
2.	Musharakah	No disbursement on both Musharakah and Salaam Financing. Reasons: (a) changes in cashew nuts season. (b) Prioritisation was placed on repayment collections for Non performing agriculture financing at Mtwara PBZ Branch. Reported NPF was 2.97%.
3.	Murabahah	Murabahah Corporate Financing (MCF) registered disbursement was TZS 1.99 billion representing performance of 56.53% of the budget amount on this segment as at 30 th June, 2022 which was TZS 3.52 billion.
4.	Istisna	Istisna Financing segment recorded no new disbursement during this period. Most of commercial financing received was in the form of working capital under Murabahah Facility.

Source: Analysed from PBZ Bank Ikhlas Quarterly Report, June 2022

5. Data and Analysis of Findings

The survey is intended to supplement information from the literature. The target population is staff at PBZ Bank Ikhlas, Members of Shariah Advisory Committee and Management where questionnaires were distributed after a brief telephone contact to confirm their willingness to participate in this survey. The findings were further enriched by consultative meetings. Data was subjected to a qualitative analysis delving into non-numerical data, open-ended responses and deeper insights.

5.1. Non-Performing Finance (NPF) as an outcome of Credit Risk

Tazara Branch registered Non-Performing Finance (NPF) of TZS 419.74 million; that is 9.30% while the limit set by BOT is 5%. Table 2 provides a summary of NPF at PBZ Bank branches across the county.

Table 2: Non-Performing Finance at PBZ Bank Branches

S/No.	PBZ Branch	Non-Performing Finance in TZS
1.	Chakechake	403.71 million equal to 3.96%,
2.	Dodoma	None
3.	Lindi	Not Reported
4.	Lumbumba	29.72 million equal to 0.37%
5.	Mtwara	84.3 million (2.975)
6.	Mpirani	386.47(2.07%)
7.	Mwanawakwerekwe	678.21 million (2.98%),
8.	Tazara	419.74 million (9.30%).
9.	Wete	None

Source: Analysed from PBZ Bank Ikhlas Quarterly Report, June 2022

When staff at PBZ Bank Ikhlas were interviewed, the response was that non-performing finance (NPF) is

an outcome of non-repayment by borrowers who fail to honor their debt obligations on what has been agreed by the Bank. They also emphasize that non-performing finance represents Credit Risk at the Bank and hence reduction on profits. Higher NPF represents lower profit margin and higher Credit Risk; normally NPF of 5% or below is acceptable or palatable. From Table 2 above Tazara Branch NPF was 9.30%, almost 5 points above palatable limit or 36% above acceptable limit.

Most of the financial transactions were in the form of Mudharabah. This is a very serious occurrence and the management has to investigate causes and come with immediate mitigation measures. Although the rest of the branches recorded NPF level at acceptable limits; any unpaid funds imply a reduction of profits to shareholders. Referring to Table 2 above, the overall NPF was 2.93% for June 2022 and 5.38% for March, 2022. The performance for credit repayment for quarter ending March, 2022 was above acceptable limits but was reduced to 2.93% by June the same year.

Regardless of the level of credit risk, a persistent proportion of NPF, if left unaddressed, could undermine the reputation of a bank and ultimately lead to a loss of customers. Further inquiries at PBZ Bank found that Mudharabah has high propensity of having Credit Riks at PBZ Bank Ikhlas with NPF at 3.52% (Table 3 above).

5.2. Islamic Financial Transactions that have high possibility of Causing Credit Risk

Officers of PBZ Bank Ikhlas were asked to rate the possibility of the following Islamic Financial Transactions in causing Credit risk. The results are presented in Table 3 below.

Table 3: Islamic Financial Transactions in causing Credit risk

S/No.	Islamic Financial Transactions	Possibility Credit Risk			
		1	2	3	None
1.	Mudharabah	4	2	5	0
2.	Murabahah	1	2	7	1
3.	Ijarah	0	5	5	1
4.	Salaam	4	5	0	2
5.	Tijara	2	3	1	1
6.	Tawarruq	3	3	4	1
7.	Istisna	2	6	1	2

Total Responses: 11

The table above shows that Mudharabah was ranked top in causing Credit Risk while Salaam and Tawarruq were ranked second. 5 respondents (45%) ranked Mudharabah and Ijarah third in causing Credit Risk; six ranked Murabahah third. Four respondents (40%) did not have any opinion on Tijarah which implies that Ijarah, Tijarah and Istisna have less likelihood of causing Credit Risk. Even with these findings, the Bank ought to be careful in dealing with Muradhabah, Salaam and Tawarruq against Credit Risk.

5.3. Application of 5Cs in Screening for Know Your Customer (KYC) and the Need to Reduce Credit Risk at PBZ Bank Ikhlas

In analyzing Credit Risk, there are five important characteristics related to customers (Know You Customers) that require observation. These are: Character of the customer; Capacity to handle the loan and business; availability of Collateral; Capital adequacy and Condition. These are known as 5Cs. Each customer should be analyzed properly to reduce none compliance in loan repayment. Table 4 below represents finding with regard to 5Cs.

Table 4: Best Applied 5Cs

S/No.	5Cs	Best Applied 5Cs			
		1	2	3	None
1.	Character	8	2	0	1
2.	Capacity	6	2	2	1
3.	Collateral	6	3	1	1
4.	Capital	3	2	4	1
5.	Condition	2	4	3	1

Total Responses: 11

Responses from PBZ Bank concerning 5Cs is that, Character is the most preferred followed by Capacity and Collateral (60% of 5Cs) while Capital and Condition (40% of 5Cs) are less preferred. This indicates lack of comprehensive screening for customers and opening doors for Credit Risk due to improper handling of KYC. Four respondents (36%) regard Capital less important in causing Credit Risk; hence they give it less importance – it is surprising. In general, Character is very important in assessing KYC. Character is also linked to political affiliation and historical background which are both high risk areas. Character may be caused by country of originality which is mostly ranked cause of Credit Risk.

5.4. Shariah Governance Issues

With respect to Shariah Governance, it was reported that this has no effect on Credit Risk. What this implies is that SAC is more careful in its deliberation and advice even though it was reported by the Board members that a major role of Risk-taking lies with Board of Directors. Table 5 below illustrates the findings.

Table 5: Sharia'h Governing Issues

S/No.	Issues in Shariah Governance (ISG)	Applicability at PBZ Bank Ikhlas			
		1	2	3	None
1.	Independence of SAC	3	1	4	3
2.	Confidentiality	3	4	1	3
3.	Competence of SAC	4	2	1	4
4.	Consistency of decisions at SAC	4	2	0	4
5.	Disclosure	6	0	1	4

Total Responses: 11

The findings on Table 5 above reveal that five respondents (45%) regard SAC firm in disclosure while four (45%) show low level of consistency. 45% of respondents did not have any opinion on Competence of SAC, Consistency of Decisions and Disclosure in decision making. This is very strange given that 60% of respondents were PBZ Bank staff associated with Shariah compliance in difference ways. The findings could imply less knowledge on the functions of SAC or that SAC lacks required competency. Finally, the Bank should be advised to enhance regular training to its staff and members of SAC to overcome competency challenges.

6. Conclusion and Suggestions on Mitigation Measures against Credit Risk

From the above findings and analysis, it is evident that Credit Risk prevails in most of People's Bank of Zanzibar (PBZ) bank branches. Reasons for such occurrences vary but most likely it is lack of in-depth due diligence on Know Your Customer (KYC) and regular training to both Shariah Advisory Committee (SAC) and Bank staff.

The following are suggestions to reduce Credit Risk at PBZ Bank Ikhlas. These findings could help in understanding the challenges and hence move forward with a broader research in the area of Risk Assessment and Mitigation. The succeeding recommendations were derived from the above analysis of findings and respondents' views. One of the most important suggestions to the Bank is to introduce Credit Rating. As this could be a challenging task, outsourcing is advised.

Unlike conventional banks which have long experience in networking, PBZ Islamic has not fully opened up its relations with organisations such as Islamic Finance Standards Board (IFSB) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). PBZ Ikhlas's participation in annual IFS activities is very low. Hence, it is recommended for PBZ Bank to strengthen collaboration with International Islamic Banks in order to benefit from their experience and expertise. Thus, the Management should enhance the Bank's participation in international forums as a way of revamping human capacity and learning from experience of others. This could also be part of continuous training for staff, management, Board and SAC members. As there is very limited scope for Islamic products in the country, exposure to international forums will enhance Bank staff competency to expand or diversified marketing approach and creation of more customer-oriented products. Thus, PBZ should create a vibrant market initiative through regular learning and interactions that will enhance business but will also reduce redundant finance.

While dynamic marketing approach could expand business, the need to enhance staff as well as community training on aspects of Islamic Banking and Finance is essential. It should not be taken for granted that banking functions and technicalities are similar all around; Islamic Banking business is generally new and

there is low level of understanding by staff, community as well as Muslim Jurisprudents. Furthermore, there should be stakeholders' engagement and transparency about Bank services and conditionality. The areas that are mostly misunderstood are Islamic Contracts and Islamic Financial Transactions.

The other area in "Knowing Your Customer", is 'due diligence' and has to be taken more seriously. The 5Cs (Character, Capacity, Collateral, Capital and Conditions) should be considered as requirements and should be made a priority in appraising customers (KYC). It is advised to consider Customer background while assessing Character to limit risk. The Bank should avoid applying 'one size fits all' approach since each individual may require different set of conditions.

'Risk-based pricing' and 'Risk-based sharing' are important considerations in mitigation against Credit Risk. In addition, there should be proper credit analysis and close customer follow up to control Credit Risk. Hence, the Bank staff need to be continuously trained and updated on different Risks areas. For both new customers and current customers, an analysis of relevant income statements and calculated debt-income ratio is necessary. This will add efforts in due diligence and KYC. Finally, customer documentation is among the priority areas.

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Islamic Preference Shares from Shariah Perspective: Case Study of Irredeemable Convertible Preference Shares (ICPS-i) Issued by TH Heavy Engineering Berhad (THHE)

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Abstract

This study investigates the Shariah compliance of Islamic Preference Shares (IPS), with particular focus on the Irredeemable Convertible Islamic Preference Shares (ICPS-i) issued by TH Heavy Engineering (THHE) Berhad. The research aims to evaluate how IPS can be adapted within the *mushārah* framework, examine divergent Shariah rulings, and assess their operationalisation and financial outcomes. The research adopts a qualitative design, combining doctrinal analysis of classical fiqh, contemporary resolutions of the IIFA-OIC, AAOIFI, and the SAC Malaysia, and statutory provisions under the Companies Act 2016. A comparative analysis highlights differing Shariah positions, while a case study of THHE's ICPS-i explores practical implementation, drawing on prospectuses, SAC resolutions, and financial statements. The findings confirm that IPS can be framed as *mushārah* instruments provided profits remain contingent on actual performance and no capital guarantees are embedded. While IIFA-OIC and AAOIFI categorically reject preference shares, SAC Malaysia adopts a more accommodative approach through mechanisms such as *tanāzul* (waiver of rights), *conditional hibah*, and recognition of the Board as *wakīl*. The THHE ICPS-i complied with SAC resolutions by ensuring profit-contingent dividends, market-based conversion, and liquidation priority via post-entitlement waiver. Financially, the instrument reduced gearing and stabilised the balance sheet but offered limited immediate returns as no dividends were declared during its tenure, underscoring the equity-like risks of IPS. This research contributes by bridging doctrinal Shariah debates and practical market application. It offers a comparative perspective on global and Malaysian rulings and provides empirical insights from the THHE ICPS-i, highlighting IPS as a hybrid financing tool that balances Shariah integrity with corporate needs.

Keywords: Islamic Preference Shares, Irredeemable Convertible Preference Shares (ICPS-i), *Mushārah*, *Tanāzul*, *Hibah*, Case study.

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1. Introduction

The Islamic Capital Market (ICM) has emerged as a cornerstone of Islamic finance, accounting for nearly one-third of global Islamic financial assets. Malaysia in particular has positioned itself as a leader, with the ICM representing 63.81% of its total capital market ([Securities Commission Malaysia, 2022](#)). The ICM provides investors with instruments that comply with Shariah principles, thereby promoting risk-sharing, transparency, and the avoidance of *riba* (interest), *gharar* (excessive uncertainty), and *maysir* (gambling).

Despite this growth, the innovation of equity-like products remains challenging. One of the most debated instruments is the Islamic Preference Share (IPS), a Shariah-compliant alternative to the conventional

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preference share. Conventionally, preference shares are hybrid instruments combining elements of debt and equity: they grant priority in dividend distribution and capital repayment but limit participation and voting rights. While they offer corporate issuers flexible financing, they are viewed with suspicion in Islamic jurisprudence because of their potential to violate *Mushārah* principles, particularly the requirements of proportional profit-sharing and shared risk of loss.

Shariah authorities are divided on their legitimacy. The International Islamic Fiqh Academy (IIFA-OIC) and AAOIFI categorically prohibit preference shares, ruling that they undermine the essence of *Mushārah* by introducing guaranteed returns and preferential rights. By contrast, the Securities Commission Malaysia's Shariah Advisory Council (SAC) has permitted preference shares under certain conditions. Through its resolutions (1999, 2022), SAC allows IPS structured through *tanāzul* (voluntary waiver of rights) and *hibah* (conditional gifting), provided that profits are distributed only when realized and no capital guarantee exists.

Against this backdrop, the issuance of Irredeemable Convertible Preference Shares (ICPS-i) by TH Heavy Engineering Berhad (THHE) provides a critical case study to evaluate the Shariah compliance and practical impact of IPS. The ICPS-i was structured in accordance with SAC guidelines and intended to serve as a Shariah-compliant financing instrument. Yet, the financial outcomes and investor experiences raise important questions about the effectiveness and desirability of such instruments.

This study therefore aims to examine the Shariah foundations, regulatory justifications, and practical implementation of Islamic Preference Shares through a detailed case study of the THHE ICPS-i. Specifically, it seeks to:

1. Analyze the fiqh adaptation (*takyif fiqhi*) of preference shares as *Mushārah* instruments.
2. Compare divergent Shariah rulings on preference shares (IIFA-OIC, AAOIFI, and SAC Malaysia).
3. Evaluate the operationalization and financial impact of ICPS-i in practice with Shariah Compliant Preference Shares parameter issued by SAC.

By integrating doctrinal analysis with an empirical case study, this research contributes to the ongoing discourse on the permissibility, structure, and role of Islamic Preference Shares within the Islamic Capital Market. It also addresses the gap between theoretical Shariah positions and real-world market practices, offering insights for scholars, regulators, and market participants on the future trajectory of preference shares in Islamic finance.

2. Literature Review

The literature on preference shares—both conventional and Islamic—reveals a longstanding debate on their legal status, economic function, and Shariah compliance. This section synthesizes key studies to provide a comprehensive understanding of preference shares and their contested role in Islamic finance.

2.1. Definition of Preference Shares

Preference shares are traditionally defined as a class of shares that confer on their holders preferential rights over ordinary shareholders, typically in relation to dividend distribution and return of capital upon liquidation, while generally restricting their voting rights (Lee, 1992; Subrahmanyam, 1977).

Under the Companies Act 2016 (Malaysia), Section 72, preference shares are legally recognised as share capital but differentiated from ordinary shares by the special rights attached to them. These may include priority in dividends, repayment of capital, or other contractual benefits, but the Act also ensures that dividends may only be paid from realised profits and subject to solvency (Section 131).

From a financial perspective, preference shares are hybrid instruments combining elements of equity and debt. They are equity because they form part of a company's permanent capital and do not carry a repayment obligation (except in the case of redeemable preference shares), but debt-like in that they often carry fixed dividend entitlements resembling interest coupons (Laurent, 2000; Manché, 2023).

2.2. Features of Preference Shares

Preference shares occupy a distinct position between ordinary shares and debt instruments. Their unique features have been well documented in corporate law, accounting, and finance literature (Subrahmanyam, 1977; Lee, 1992; Bratton & Wachter, 2013; Manché, 2023).

2.2.1. Dividend Priority

One of the most defining features of preference shares is their priority in dividend distribution compared to ordinary shares. This right means that dividends must be paid to preference shareholders before any distribution is made to ordinary shareholders (Subrahmanyam, 1977; Lee, 1992).

a) Legal and Corporate Finance Perspective

Under company law (e.g., Companies Act 2016, Section 72 in Malaysia; UK Companies Act 2006, s. 629), preference shareholders are entitled to a dividend as specified in the share terms, typically expressed as a fixed percentage of the share's nominal or issue value. However, the declaration of dividends remains subject to the discretion of the board of directors and is conditional upon the existence of distributable profits. This distinguishes dividends on preference shares from interest on debt, which constitutes a contractual obligation regardless of profitability (Bratton & Wachter, 2013).

b) Fixed vs. Variable Rates

In practice, most preference shares are issued with a fixed dividend rate. This provides investors with more predictable income compared to ordinary shares, where dividends fluctuate with profits. Some preference shares, however, may include variable or participating dividend features, linking payments to company performance (Laurent, 2000).

c) Cumulative vs. Non-Cumulative

Dividend priority may be further structured as:

- Cumulative preference shares: if dividends are not declared in one financial year, they accumulate and must be paid in subsequent years before ordinary shareholders receive any dividends.
- Non-cumulative preference shares: dividends lapse if not declared in a given year. The cumulative form is generally considered more protective of investor interests and is more common in markets such as India and the UK (Subrahmanyam, 1977; Manché, 2023).

d) Implications in Accounting and Finance

From an accounting perspective, the nature of the dividend entitlement is a key determinant in classification.

- If dividends are obligatory (e.g., fixed and cumulative, with redemption terms), the preference shares may be classified as liabilities under IFRS/MFRS.
- If dividends are discretionary (e.g., non-cumulative, contingent on profits), the shares are more likely to be treated as equity (IFRS IAS 32; MFRS 132).

In corporate finance, dividend priority makes preference shares attractive to investors seeking security and predictable income. However, because dividends are not tax-deductible (unlike interest on debt), they represent a higher after-tax cost of capital for the issuing company (Laurent, 2000). This has limited the widespread use of preference shares in many jurisdictions, where debt is often preferred for financing.

2.2.2. Capital Priority on Liquidation

Another defining feature of preference shares is their priority in the distribution of capital upon liquidation or winding up of a company. This right distinguishes preference shareholders from ordinary shareholders, though they still rank subordinate to creditors.

a) Legal Perspective

In company law, preference shareholders are entitled to repayment of their capital before ordinary shareholders receive any residual assets, but only after secured and unsecured creditors have been satisfied. This principle is recognized across common law jurisdictions and is codified in statutes such as the Companies Act 2016 (Malaysia), Section 72, which defines preference shares as shares that carry preferential rights in respect of

dividends or capital repayment compared with ordinary shares. Similarly, under the UK Companies Act 2006 (s.629), preference shareholders are expressly distinguished by their entitlement to priority distributions. This priority is a contractual right attached to the class of shares and must be clearly stated in the company's constitution or terms of issuance. In practice, preference shareholders often have the right to receive the par value or issue price of their shares before ordinary shareholders participate in the residual assets.

b) Accounting Perspective

From an accounting standpoint, capital priority may affect the classification of preference shares under international and local financial reporting standards. According to IAS 32 / MFRS 132, the classification of preference shares depends on their substance rather than legal form. Where redemption or repayment obligations exist, preference shares are treated as financial liabilities, since the issuer has a contractual obligation to deliver cash or another financial asset. In contrast, irredeemable preference shares without repayment obligations are typically classified as equity instruments ([International Accounting Standards Board, 2003](#)).

Scholars such as [Bratton and Wachter \(2013\)](#) and [Manché \(2023\)](#) further highlight that this hybrid treatment reflects the ambiguous nature of preference shares: legally they remain part of share capital, but in financial reporting they may be booked as debt when fixed repayment or redemption rights are embedded.

c) Corporate Finance Perspective

In financial terms, the liquidation preference enhances the security of preference shareholders relative to ordinary shareholders, making the instrument more attractive to conservative investors. However, because preference shareholders remain subordinated to creditors, the feature does not eliminate investment risk. In fact, empirical studies ([Subrahmanyam, 1977](#); [Laurent, 2000](#); [Manché, 2023](#)) note that preference shareholders often recover little in insolvency cases, particularly when companies have significant outstanding debt obligations.

The capital priority feature, therefore, gives preference shares an intermediate position: they offer investors a stronger claim than ordinary equity, but weaker protection compared to debt instruments such as bonds.

2.2.3. Voting Rights

Another distinctive feature of preference shares is their generally restricted voting rights compared to ordinary shares. While ordinary shareholders typically exercise full voting rights on matters such as board appointments, business strategy, and major corporate decisions, preference shareholders are usually limited to specific circumstances.

a) Legal Perspective

Under company law, preference shareholders may be excluded from ordinary voting but are entitled to vote on matters that directly affect their class rights. For instance, the Companies Act 2016 (Malaysia, Section 90) provides that any variation of class rights must be approved by a special resolution of the affected class of shareholders. Similarly, the UK Companies Act 2006 (s.630–633) requires class consent when rights are altered. In addition, preference shareholders may obtain voting rights if dividends remain unpaid for a specified number of periods, often two or more consecutive years.

b) Corporate Governance Perspective

The restriction of voting rights reflects the traditional understanding of preference shareholders as investors primarily interested in priority income and capital protection, rather than corporate control. [Bratton and Wachter \(2013\)](#) observe that this separation of economic interest from governance rights has historically created tensions in corporate governance, especially in cases where preference shares are widely held. In venture capital contexts, [Korsmo \(2013\)](#) notes that preference shares may be structured with enhanced

protective provisions, including veto rights on major decisions, to safeguard investors without granting them general voting parity with ordinary shareholders.

c) Finance Perspective

From a corporate finance standpoint, limiting the voting rights of preference shareholders allows companies to raise capital without significantly diluting control of existing ordinary shareholders. This makes preference shares attractive to founders and controlling shareholders, particularly in family businesses or closely-held companies (Manché, 2023). However, it also makes preference shares less attractive to investors who seek both economic return and influence in governance, explaining their limited popularity in many capital markets.

2.2.4. Redeemability

A further characteristic of preference shares is their potential to be redeemable. This means the issuing company may buy back the shares after a specified period, at a fixed price, or at its discretion. Redeemability gives companies flexibility in structuring capital, while distinguishing preference shares from ordinary shares, which are generally irredeemable.

a) Legal Perspective

In Malaysia, the Companies Act 2016 (Section 72(5)) permits the issuance of redeemable preference shares, provided the redemption does not compromise the company's solvency. Redemption may be funded from distributable profits or the proceeds of a fresh issue of shares. Similar provisions exist in the UK Companies Act 2006 (Sections 684–689), where redemption must not prejudice creditor protection. The law thereby balances corporate financing flexibility with safeguards against excessive capital erosion.

b) Accounting Perspective

The redeemability feature has direct implications for financial reporting. Under IFRS IAS 32 / MFRS 132, redeemable preference shares with a contractual obligation to repay capital at maturity are classified as financial liabilities, since the issuer cannot avoid delivering cash or another financial asset. In contrast, irredeemable preference shares, which have no repayment obligation, are treated as equity. This dual classification underscores the hybrid character of preference shares (IASB, 2003; Bratton & Wachter, 2013).

c) Finance Perspective

From a corporate finance standpoint, redeemable preference shares offer issuers a way to raise equity-like funds temporarily, with the option to restructure capital later. They may be used to finance specific projects, bridge capital requirements, or provide flexibility in capital restructuring. However, because dividends on redeemable preference shares are not tax-deductible, they are more expensive than debt financing. Empirical studies (Laurent, 2000; Manché, 2023) show that companies tend to issue redeemable preference shares during periods of financial distress or when retaining control is a priority, making them a relatively niche instrument.

2.2.5. Convertibility

Another common feature of preference shares is their convertibility into ordinary shares. Convertible preference shares (CPS) give holders the option, or in some cases impose an obligation, to exchange their preference shares for ordinary equity after a specified period or upon meeting certain conditions. This feature adds flexibility for both investors and issuers, linking the fixed-income style benefits of preference shares with the growth potential of common stock.

a) Legal Perspective

Most company law frameworks, including the Companies Act 2016 (Malaysia, Section 72), allow the issuance of convertible preference shares, subject to terms set out in the company's constitution or prospectus. Conversion terms typically specify the conversion ratio, timeframe, and whether conversion is mandatory or

optional. The UK Companies Act 2006 similarly recognises convertible preference shares as part of permissible share capital, provided shareholder approval is obtained and class rights are respected.

b) Accounting Perspective

The convertibility feature complicates the classification of preference shares in financial reporting. Under IFRS IAS 32 / MFRS 132, a compound financial instrument (such as convertible preference shares) must be split into its liability and equity components at initial recognition. The liability component reflects the issuer's obligation to pay dividends or redeem, while the equity component reflects the embedded option to convert into ordinary shares (IASB, 2003). This dual recognition underscores the hybrid nature of convertible preference shares and affects how they are reported in balance sheets.

c) Finance Perspective

From a financial standpoint, convertible preference shares appeal to investors by offering downside protection through preferential rights and upside potential through conversion into ordinary equity. For issuers, convertibility provides a mechanism to raise funds without immediate dilution of control, while retaining the option of future equity participation by investors. Studies in corporate finance (Laurent, 2000; Bratton & Wachter, 2013) note that firms often prefer convertible instruments when facing uncertainty in future cash flows, since convertibility can reduce financing costs relative to straight preference shares.

Table 1: Summary of key features of Preference Shares

Feature	Summary
Dividend Priority	Preference shareholders receive dividends before ordinary shareholders, usually at fixed or indicative rates, subject to distributable profits and board declaration.
Capital Priority on Liquidation	Entitled to repayment of capital before ordinary shareholders but after creditors.
Voting Rights	Generally, no voting rights, except on matters affecting class rights, winding up, or prolonged dividend arrears.
Cumulative / Non-Cumulative	Cumulative: unpaid dividends accrue to future years. Non-cumulative: lapse if not declared.
Redeemability	May be redeemed (bought back) by the company after a set period or at its discretion; irredeemable shares form permanent capital.
Convertibility	Can be converted into ordinary shares at a predetermined ratio and time.
Hybrid Character	Legally equity, but accounting treatment may classify them as equity or liability depending on terms.

2.3. Shariah Resolutions on Preference Shares

The legitimacy of preference shares in Islamic finance has been the subject of significant debate, with divergent positions among global and local Shariah authorities.

2.3.1. Fatwas on the impermissibility of preference shares:

- i. The IIFA-OIC 1992 resolved that: "It is not permissible to issue preference shares, which have financial features that lead to a guarantee of capital and fixed return, priority [over other shareholders] in the event of liquidation or at profit distribution."
- ii. The IIFA-OIC 2003 further resolved that: "... it is not permissible for a company to issue preferred shares or preference shares or debentures. Fourthly, in occasions when the company suffers losses, it is compulsory for every shareholder to bear his share of the loss, in proportion to his capital contribution."
- iii. AAOIFI in Shariah Standard No. 12 (Item 4/1/2/14) states that: "It is not permitted to issue preference shares, i.e. shares that have special financial characteristics that give them a priority at the date of liquidation of the company or at the date of distribution of profit. However, it is permissible to grant

certain shares, in addition to being entitled to rights attached to common shares, certain procedural and administrative privileges, such as the right of vote.”

2.3.2. Resolution on the permissibility of preference shares:

By contrast, the Shariah Advisory Council (SAC) of the Securities Commission Malaysia has adopted a more accommodative approach:

- i. 1999 Resolution: SAC permitted non-cumulative preference shares based on the concept of tanāzul (voluntary waiver of rights). Ordinary shareholders may waive their entitlement to profits in favor of preference shareholders after profit realization. However, cumulative preference shares were rejected for resembling guaranteed entitlements.
- ii. 2022 Resolution: SAC expanded its framework by allowing modified cumulative features, subject to availability of profit. The SAC ruled that:

Preference shareholders are partners (mushāriks) under the Mushārahah contract.

- a) They may receive dividends up to the declared profit, with expected dividend rates considered indicative only.
- b) Tanāzul (waiver of rights) and wa‘d bi al-hibah (promise to gift) may be applied, provided waivers occur after rights are established.
- c) Features such as voting rights, participation, convertibility, and redeemability are permissible if structured without capital/profit guarantees.
- d) Dividends must comply with Companies Act 2016, Section 131, which requires distribution only from realized profits and prohibits payments that render the company insolvent.

It is noted that there are contradictory views on the issue of the permissibility of preference shares. The contradictions stem from different understanding of the nature of preference shares. (Nasr & Hasan, 2021). Thus, it is pertinent to provide a comparative analysis of the opposing approaches on preference shares. It is worth noting that the permissibility of preference shares provided by SAC SC is based on the mechanism of tanazul and hibah, which require further analysis aside from the main Mushārahah concept.

2.3.3. Comparative Analysis

i. Substance of Priority versus Timing of Priority

The most fundamental divergence concerns whether financial priority itself is permissible in mushārahah. The International Islamic Fiqh Academy (IIFA) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) prohibit preference shares that grant priority in dividends or liquidation, arguing that such privileges undermine the pari passu principle of mushārahah. By contrast, the Shariah Advisory Council (SAC) of the Securities Commission Malaysia reconceptualises priority as an outcome that is executed only after rights arise, such as upon the declaration of profit or at liquidation. This is operationalised through mechanisms like tanāzul (waiver of rights) or conditional hibah, thereby maintaining the requirement of shared risk ex ante (Mohamad et al, 2017; AlSuhailani, 2014).

ii. Mechanism Design: Tanāzul and Conditional Hibah

Early Malaysian practice relied heavily on tanāzul. However, scholars have highlighted issues with upfront waivers, which may constitute isqāt mā lam yajib (waiving a right before it accrues) and potentially introduce gharar into contracts (Ahmad & Bakar, 2017; Mohd Noor et.al, 2015). To address this concern, the SAC and contemporary researchers have advocated the use of conditional hibah (hibah mu‘allaqah). Conditional hibah takes effect only once profits have been realised, thus avoiding the doctrinal objection of premature waiver and ensuring conformity with fiqh principles of conditional transactions (Ahmad et al., 2020; Mohamad et.al 2017).

iii. Dividend Doctrine: Profit-Contingent Principle

Despite differing stances on permissibility, Shariah bodies converge on the principle that dividends must remain contingent on realised profits. Guaranteed or fixed returns are unanimously rejected as incompatible with Shariah (AlSuhailani & Naifar, 2014; Mohamad et.al, 2017). The SAC resolution of 2022 underscores this by clarifying that any “expected dividend rate” should be treated as indicative only, while dividend distributions

must comply with statutory safeguards such as Section 131 of the Companies Act 2016, which restricts payments to available profits and requires solvency (Nasr & Hassan, 2024).

iv. Operational Governance: Board as Wakīl

A further innovation by the SAC (2022) is the recognition that the Board of Directors may act as wakīl (agent) on behalf of ordinary shareholders in executing tanāzul. This development solves the practical difficulty of obtaining shareholder-wide consent for every distribution and ensures that the waiver occurs only after rights have materialised (Mohamad et.al, 2017; Ahmad et al., 2021).

i. Scope and Instrument Design

Finally, there is divergence in the scope of permissible features. AAOIFI permits only procedural or administrative distinctions (e.g., voting arrangements) and prohibits financial privileges such as dividend or liquidation preference (AAOIFI, 2010). Conversely, the SAC (2022) adopts a broader approach by allowing features such as participation, convertibility, and redeemability, so long as they do not create capital or profit guarantees and are exercised only after entitlements arise (Zarka & Shubaini, 2012; Nasr & Hassan, 2024).

Table 2: Comparative Table between Shariah resolutions

Dimension	IIFA-OIC	AAOIFI (Shariah Std. No.12)	SAC Malaysia (1999)	SAC Malaysia (2022)
Overall stance	Non-permissive: Pref. shares not allowed due to guaranteed/privileged financial rights (fixed returns, priority at profit/liquidation).	Non-permissive for financial priority; only procedural/administrative distinctions allowed (e.g., voting).	Conditional permissibility of non-cumulative preference shares via tanāzul (waiver by ordinary shareholders).	Expanded conditional permissibility: mushārahah basis; post-realisation priority via tanāzul or conditional hibah; profit-contingent and no guarantees.
Underlying contract (takyif)	Pref. shares conflict with mushārahah's loss-sharing and pari passu profit.	Similar rationale; priority in profit/liquidation contradicts mushārahah substance.	Treatable within mushārahah if priority is achieved through voluntary waivers (tanāzul).	Explicit mushārahah framing with detailed mechanics (tanāzul/hibah) and governance guardrails.
Dividend treatment	Fixed/guaranteed returns unacceptable.	Financial priority at profit distribution not permitted.	Non-cumulative only; dividends remain discretionary and profit-based.	Expected dividend rate indicative only; must follow Companies Act s.131 (profit availability & solvency).
Liquidation priority	Priority at liquidation contributes to impermissibility.	Same: financial priority at liquidation not permitted.	Permitted only if effected by tanāzul (ordinary shareholders waive after entitlement arises).	Reaffirms priority only post-entitlement, executed by Board as wakīl for ordinary shareholders.

Capital guarantee	Not allowed; contradicts mushārahah loss-bearing.	Not allowed; partner cannot guarantee another's capital.	Not allowed.	Not allowed (and aligned with company law).
Cumulative dividends	—	—	Not permitted (resembles guarantee).	Modified cumulative features may be acceptable subject to realised profit (no guarantee).
Mechanism	—	—	Tanāzul (shareholders' waiver).	Tanāzul (via Board-as-wakīl) and conditional hibah (post-condition gift).
Timing requirement	—	—	Waiver implied, but timing less elaborated.	Critical: waiver/hibah only after profit/liquidation rights arise (no upfront waiver).
Other features (voting, convertibility, redeemability)	—	Only procedural distinctions are acceptable.	Limited discussion; non-cumulative focus.	Permissible if they do not create guarantees; convertibility/redeemability possible within mushārahah-compliant terms.

2.4. Shariah Discussion in Preference Shares

The evaluation of preference shares in Islamic finance must begin with the basic principles of mushārahah, where partners contribute capital, share profits according to an agreed ratio, and bear losses in proportion to their capital contributions. These parameters serve as the benchmark for assessing the features of preference shares.

This discussion is divided into two parts. The first outlines the parameters of mushārahah and maps them against the main features of preference shares, such as dividend priority, capital rights, voting restrictions, redeemability, and convertibility. The second part highlights the main Shariah issues arising from these features, including guaranteed dividends, capital protection, and liquidation priority, and then considers proposed solutions such as tanāzul and conditional hibah.

The aim is to show how preference shares may be aligned or conflicted with Shariah principles, and to review the mechanisms developed in contemporary practice to address these concerns.

2.4.1. Overview of Mushārahah Contract

This section will provide a general overview and relevant fiqh issues and discussions surrounding the Mushārahah (partnership) contract.

Mushārahah is a partnership between two or more parties to finance a business venture, where all parties contribute capital in the form of cash or in-kind. The term "Mushārahah" is derived from the word "Shaaraka," which means to share. It is widely used in the context of equity-based Islamic financing and connotes a limited understanding compared to the term "Shirkah" (sharing or partnership) used in Islamic jurisprudence literature. Mushārahah can be divided into two categories: Shirkah Al-Milk, which refers to joint ownership of a particular property, and Shirkah Al-Aqd, which is a contractual partnership for commercial goals. (Hisyam, 2019).

The followings are basic characteristic of Mushārahah:

1. The distribution of profit in the context of mushārahah is based on the actual profit accrued to the business, rather than a predetermined or fixed amount. The agreement between partners should specify an agreed percentage of the actual profit, which will be distributed accordingly at the end of the term. It is emphasized that any predetermined lump sum or a certain percentage of the investment as a basis for profit distribution would render the contract invalid (Usmani, 1999).

2. The distribution of loss is a fundamental aspect governed by Islamic jurisprudence. All partners must bear the loss exactly according to the ratio of their investment. This means that if a partner has invested 40% of the capital, they must bear 40% of the loss, and any condition to the contrary would render the contract invalid according to Shariah. This principle is unanimous among Muslim jurists. (T. B. Hisyam, 2019; Usmani, 1999).
3. The dissolution of Mushārahah, a partnership in Islamic finance, can occur through mutual agreement among the partners. It may be dissolved when it reaches its maturity, as predetermined in the contract, or by the agreement of all partners. (AAOIFI, Shariah Standards). Additionally, a partner may serve a withdrawal notice to quit the partnership. Upon dissolution, the assets of the Mushārahah are distributed between the partners on a pro rata basis, provided that the capitals are in the form of cash. If the capitals are in another form, the partners must mutually agree on whether to resort to liquidation or partition of the assets. In the event that the Mushārahah is to continue without a partner, the remaining partners may choose to purchase the leaving partner's share. If there is a dispute over the share price, the leaving partner may compel the other partners to liquidate or distribute the assets among themselves. This process ensures fairness and mutual agreement in the dissolution of the Mushārahah partnership.

Table 3: Mapping Mushārahah Parameter with Preference Shares

Mushārahah Parameter	Key Requirement	Relevant Features of Preference Shares	Alignment / Potential Conflict
Profit Distribution (Usmani, 1999)	Profit must be distributed from <i>actual realised profits</i> ; ratios must be pre-agreed; fixed amounts or predetermined percentages of capital are invalid.	Dividend Priority (fixed or indicative dividends); Cumulative/Non-Cumulative Dividends; Participating/Non-Participating rights.	Conventional preference shares often stipulate fixed dividends, which may conflict with the mushārahah requirement of profit-contingent distribution. Non-cumulative and participating preference shares are closer to mushārahah principles, but fixed dividend entitlement remains problematic.
Loss Sharing (Usmani, 1999; Hisyam, 2019)	Losses must be borne strictly in proportion to capital contributions; conditions shifting losses away from one partner are invalid.	Capital Priority on Liquidation; Capital Guarantee (implicit or explicit).	Preference shares typically grant priority in capital repayment during liquidation. This creates asymmetry in risk-sharing, as preference shareholders are shielded relative to ordinary shareholders. Such protection conflicts with mushārahah's unanimous requirement of <i>pari passu</i> loss sharing.
Dissolution of Mushārahah (AAOIFI Shariah Standards)	Dissolution may occur by mutual agreement, maturity, or withdrawal. Upon dissolution, assets are distributed <i>pro rata</i> . If in non-cash form, partners must agree on liquidation or partition.	Redeemability (company repurchases shares); Convertibility (conversion into ordinary shares); Hybrid Character.	Preference shares with redeemable features may align partially with voluntary dissolution, but redemption guarantees contradict mushārahah principles. Conversion into ordinary shares provides flexibility and may reflect equitable continuation, but liquidation priority remains inconsistent with the <i>pro rata</i> principle.

2.5. Shariah issues of preference shares

As highlighted in previous section, the structuring of preference shares raises a number of significant Shariah concerns that have been widely debated in both scholarly literature and among standard-setting bodies. These

issues primarily relate to the alignment of preference share features with the principles of *mushārah* and the prohibition of *riba*, *gharar*, and unjustified guarantees. This section will focus on the issues that have been discussed and the proposed solution.

2.5.1. *Guaranteed or Fixed Dividends*

A key objection to conventional preference shares is the entitlement to fixed or guaranteed dividends. Such arrangements closely resemble interest payments on debt instruments, as they provide a predetermined return regardless of profit realisation (AISuhaibani & Naifar, 2014). Shariah requires that profits be contingent upon actual business performance, and therefore guaranteed dividends are considered inconsistent with the principle of *al-kharāj bi al-damān* (entitlement to return is justified only by assuming risk) (IIFA, 2003; AAOIFI, 2010).

Nevertheless, SAC is of the view that from Shariah perspective, it is permissible for preference shareholders to receive dividend up to the declared profit by the company based on the concept of *taradhi* (mutual consent). Consent is an essential element of contract validity from *fiqh* perspective, as highlighted in

Surah Al-Nisa “O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent” (4:29). The entitlement of profit to preference shareholders is understandable since it is their right as *Musharik*.

SAC also is of the view that “in the context of Shariah-compliant preference shares, there is no capital and/ or profit guarantee by the company to the preference shareholders. This is because the dividend rate determined in the terms and conditions of the preference shares (whether cumulative or non-cumulative) is only indicative. The dividend rate is also not considered as debt by the company to the preference shareholders because the dividend declaration to be distributed to the preference shareholders is subject to the availability of profit of the company, in line with Section 131 of the Companies Act 2016”.

Based on the above, the SAC view that the imposition of expected dividend rate is only indicative due to the distribution of dividend payout must be subjected to the availability of profit as required by Section 131 of the companies act. The indicative rate is acceptable from shariah perspective and in line with requirement highlighted in *Musyarakah Policy Document* of BNM which states that the expected return in the form of a percentage which is attributed to the capital amount is only permissible in the form of indicative profit rate.

Further examination on Section 131 of the companies act noted that the distribution is guided by two (2) principles; first, the dividend is to be paid out of the company's profits; and the second principle is the dividend should not be paid if the payment will cause the company to be insolvent:

131. (1) Subject to section 132, a company may only make a distribution to the shareholders out of profits of the company available if the company is solvent.

It can be concluded that the profit guarantee is not allowed and acceptable by law, thus eliminating it from the features of preference shares. The elimination of the profit guarantee element results in the compliance of preference shares with *Mushārah* concept.

2.5.2. *Capital Guarantee and Loss Sharing*

Another concern is the guarantee of capital repayment or disproportionate protection of preference shareholders during losses. In a *mushārah* framework, all partners must share losses in proportion to their capital contributions. By granting preference shareholders superior rights to recover their capital, conventional structures undermine this fundamental principle (Mohamad et al, 2017; Ahmad et.al, 2017). Both IIFA and AAOIFI have therefore rejected preference shares that provide any form of capital protection.

On the other hand, the SAC emphasised that redemption and conversion features in preference shares do not constitute a capital guarantee. Redemption is only permissible if executed through purchase or sale undertakings that are tied to the market value of the shares at the redemption date or the performance of the company. Similarly, conversion into ordinary shares must reflect the prevailing market price at the time of conversion. These conditions ensure that preference shareholders remain exposed to business risk and cannot demand their full capital back in all circumstances.

2.5.3. Priority in Liquidation

Preference shareholders often enjoy priority rights over ordinary shareholders during liquidation. While this feature is common in corporate law, it presents a Shariah issue since it alters the *pari passu* principle of partnership distribution. Some scholars argue that such priority privileges recharacterise preference shares into quasi-debt instruments (Ahmad & Bakar, 2017). Others, however, have suggested that priority may be tolerated if implemented through *tanāzul* by ordinary shareholders after entitlement arises (Mohd Noor et al., 2014).

The later view is in line with SAC position in which the committee makes a clear distinction between a guarantee of priority—which is impermissible—and a voluntary waiver mechanism that achieves a similar effect without violating Shariah principles. In its 261st resolution, the SAC clarified that priority for preference shareholders during liquidation may be realised through post-entitlement *tanāzul*, in which ordinary shareholders voluntarily relinquish their residual rights in favour of preference shareholders. To facilitate this mechanism in practice, the SAC further permitted the Board of Directors to act as *wakīl* (agent) on behalf of ordinary shareholders, executing the waiver only once liquidation entitlements have crystallised. This arrangement ensures compliance with Shariah by avoiding *isqāt mā lam yajib* (the invalid waiver of a right before it arises) and prevents the element of *gharar* (uncertainty) (SAC, 2022).

2.5.4. The Issue of Upfront Tanāzul

The use of *tanāzul* (waiver of rights) in Malaysian practice initially offered a mechanism to legitimise preference share structures. However, significant criticism has emerged around upfront *tanāzul*, where ordinary shareholders waive rights before they have accrued. This is considered problematic since Shariah prohibits *isqāt mā lam yajib* (waiving what has not yet become due) and may introduce elements of *gharar* (uncertainty) (Mohamad et al. 2017; Ahmad & Bakar, 2017).

2.5.5. Conditional Hibah as part of Solution

Recent scholarship has proposed conditional hibah (*hibah mu'allaqah*) as a stronger alternative to *tanāzul*. Under this mechanism, ordinary shareholders issue a gift promise that becomes effective only after profits are realised, thereby avoiding premature waiver of rights and ensuring compliance with fiqh rules governing conditional contracts (Ahmad et al., 2020; Mohamad et al., 2017). The SAC Malaysia (2022) has also endorsed this mechanism, recognising conditional hibah as a practical and Shariah-compliant method of granting preference rights while safeguarding the *mushārahah* foundation.

Table 4: Summary of Shariah issues in Preference Shares and Proposed Solutions

Issue	Shariah Concern	Scholarly / Institutional Position	Proposed Solution
Capital Guarantee and Loss Sharing	Guarantee of capital repayment or disproportionate protection of preference shareholders undermines <i>mushārahah</i> rule that losses must be borne in proportion to capital.	IIFA and AAOIFI reject any form of capital protection (Mohamad et al., 2017; Ahmad et al., 2017).	SAC clarifies that redemption must be linked to market value/performance, and conversion must reflect prevailing market price, ensuring shareholders remain exposed to risk.
Priority in Liquidation	Priority rights in liquidation alter the <i>pari passu</i> principle of partnership and resemble debt-like instruments.	Some scholars reject liquidation priority (Ahmad & Bakar, 2017), while others allow it via <i>tanāzul</i> after entitlement (Mohd Noor et al., 2014). SAC (2022) permits post-entitlement <i>tanāzul</i> , executed by the Board as <i>wakīl</i> , avoiding <i>isqāt mā lam yajib</i> .	Priority implemented through post-entitlement <i>tanāzul</i> , not guarantee. Board acts as agent to execute waiver only after entitlements crystallise.

Upfront Tanāzul	Waiver of rights before they accrue constitutes <i>isqāt mā lam yajib</i> and introduces <i>gharar</i> (uncertainty).	Criticised by scholars as impermissible (Mohamad et al., 2017; Ahmad & Bakar, 2017).	Replace upfront waivers with conditional mechanisms that activate only after profit realisation.
Conditional Hibah	Need for mechanism to provide preference without violating Shariah principles.	Supported by contemporary scholars and endorsed by SAC Malaysia (2022) (Ahmad et al., 2020; Mohamad et al., 2017).	Conditional hibah (hibah mu'allaqah) ensures that rights are transferred only after profit realisation, avoiding premature waivers and safeguarding <i>mushārah</i> principles.

2.6. Gap Analysis

It is observed that the following areas may require further study:

- a. Harmonization between the two Shariah approaches (Middle East vs Malaysia) on the permissibility of Islamic preference shares including critical analysis on recently issued SAC resolution on preference shares. The related studies focus on Shariah issues but did not provide a preference (tarjih) or harmonization attempt between the opposing approaches.
- b. The need to examine the implementation of preference shares in the Market. Based on Bursa Malaysia website, there are a few public listed companies that issued a variety of preference shares (redeemable, irredeemable, convertible, etc) such as SP Setia Berhad, Sapura Energy, Sunway and TH Heavy Engineering. The study on the actual case can provide a better understanding of the operationalization and impact of preference shares and also ascertain its conformity to the SAC resolution.

3. Research Methodology

This study adopts a qualitative research design in order to examine the Shariah compliance of Islamic Preference Shares, with specific reference to the Irredeemable Convertible Preference Shares (ICPS-i) issued by TH Heavy Engineering Berhad (THHE). The qualitative approach is appropriate given the exploratory nature of the study and its focus on textual analysis of Shariah resolutions, legal provisions, and corporate documents. The methodology combines document analysis, literature review, and case study to ensure a comprehensive triangulation of findings.

3.1. Research Design

3.1.1. Document Analysis

This method will focus on the rulings of the International Islamic Fiqh Academy (IIFA), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the Shariah Advisory Council (SAC) of the Securities Commission Malaysia. Statutory provisions such as the Companies Act 2016, and international accounting standards (IAS 32 / MFRS 132) are also reviewed to establish the legal and regulatory context for preference shares. This method provides the normative framework against which practical instruments can be evaluated.

3.1.2. Literature Review

This method entails an in-depth literature review involving scholarly articles, reports, and other pertinent publications related to Islamic Preference Shares. The objective is to acquire a comprehensive understanding of the subject and to identify any existing gaps in the current body of research. This thorough exploration will contribute to the development of a well-informed framework for analyzing Islamic Preference Shares.

3.1.3. Case Study

The third component is an exploratory case study of the THHE ICPS-i issuance, selected as it represents one of the earliest applications of Shariah-compliant preference shares in the Malaysian capital market. Company filings, prospectuses, and official announcements are examined to identify the contractual features embedded in the instrument, such as dividend structure, priority rights, and conversion or redemption mechanisms. These features are then mapped against Shariah parameters of Islamic preference shares to assess compliance and identify areas of innovation or tension.

3.2. Data Analysis

The analysis proceeds in three stages:

1. Shariah and Fiqh Analysis – Textual analysis of classical juristic views on Mushārah, profit-sharing, capital guarantees, and waiver of rights. This establishes a normative framework against which preference share structures are evaluated.
2. Comparative Resolution Analysis – Systematic comparison of rulings by IIFA-OIC, AAOIFI, and SAC Malaysia. Special attention is given to the 2022 SAC resolution, which introduces innovative mechanisms such as tanāzul and wa'd bi al-hibah. The analysis seeks to explain how these mechanisms reconcile Shariah principles with market realities.
3. Case Study Analysis – The THHE ICPS-i case is examined to assess whether its features and implementation align with the SAC's 2022 resolution and Mushārah principles. Financial performance data (2015–2020) is used to evaluate whether dividends were paid, how conversion occurred, and whether elements of profit guarantee or capital protection were present.

4. Case Study: Irredeemable Convertible Islamic Preference Shares (ICPS-i Issued by THHE Berhad).

This case study is organised into four parts. The first explains the structure of the ICPS-i, followed by a discussion of its key features such as dividend rights, conversion, and voting. The third part reviews the financial impact of the issuance on THHE's capital position, while the final part examines its compliance with SAC resolutions on preference shares. Together, these perspectives provide a practical view of how preference shares are applied in an Islamic framework.

4.1. Structure and Transaction Flow

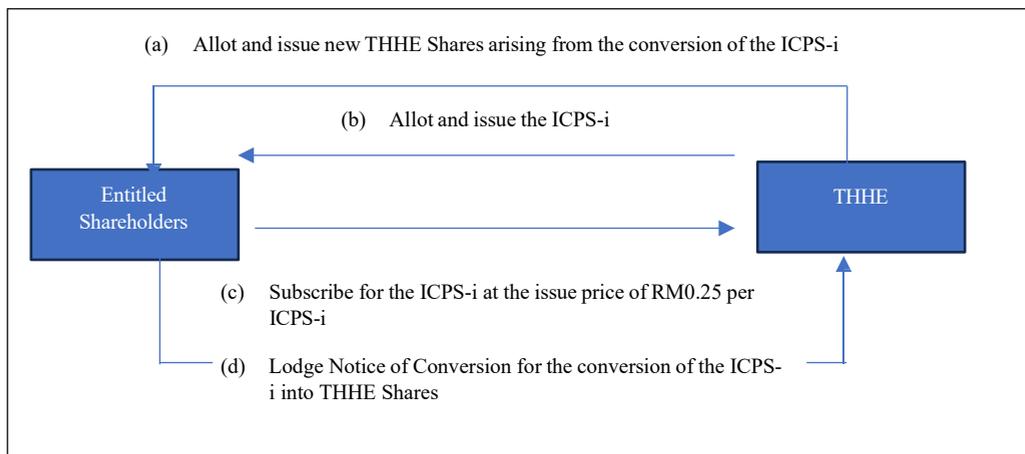


Figure 1: ICPS-i Structure of THHE

Source: Abridged Prospectus dated 14 August 2015

This diagram outlines the process of subscribing for the ICPS-i, converting the ICPS-i into THHE Shares, and the issuance of new THHE Shares resulting from the conversion. It also includes the involvement of renounees/transferees/underwriters who subscribe for the ICPS-i.

4.2. Features of ICPS-i

The Islamic Irredeemable Convertible Preference Shares (ICPS-i) proposed by TH Heavy Engineering Berhad (THHE) have several key features:

1. **Transferability:** The ICPS-i can be transferred to other parties through mechanisms recognized by Shariah, such as sale contracts or hibah. This is in line with SAC resolution.
2. **Mandatory Conversion:** The ICPS-i is convertible, at the option of the holder, at any time during the conversion period without the payment of additional consideration. The conversion period is from the date of issue up to the maturity date, and the conversion rate is one new THHE Share for one ICPS-i held. The conversion rate is mutually agreed which is in line with taradhi concept highlighted by SAC.
3. **Rights and Responsibilities of ICPS-i Holders:** ICPS-i holders have the right to receive dividends in proportion to their shareholdings, with a targeted aggregate dividend rate of 20% over the tenure of the ICPS-i. They also have the right to exit from the agreement at any time by selling their ICPS-i on the open market of Bursa Securities. Additionally, they agree to waive their right to vote at general meetings of THHE, except in specific circumstances. The targeted aggregate rate is indicative and subject to the availability of the profit which means that the ICPS-i does not guarantee on the profit return in line with Mushārah concept.
4. **Shariah-Compliant Status:** THHE aims to maintain its Shariah-compliant status, but there is no guarantee. If THHE becomes Shariah non-compliant, ICPS-i holders have the right to sell the ICPS-i on the market. The company involved in offshore fabricator and shipbuilder is deemed Shariah-compliant based on the assessment methodology of Securities Commissions Malaysia
5. **Dividend Preference:** ICPS-i holders are entitled to a targeted aggregate dividend rate of 20% throughout the 5-year tenure, subject to the availability of distributable profits. The distribution of dividends is subject to ratification by the Board. The waiver of dividends is happening after realisation of profit in line with the majority of the scholars view on the validity of the waiver; whether via tanazul, ibrah' or hibah; to be executed after the materialization of the rights to the waiver.
6. **Winding up or Liquidation Preference:** ICPS-i holders will rank in priority to THHE Shares in any distribution of assets in the event of liquidation, dissolution, or winding-up, subject to ratification by the Board. The waiver of capital recoup is happening during the dissolution which is in line with the majority of the scholars view on the validity of the waiver; whether via tanazul, ibrah' or hibah; to be executed after the materialization of the rights to the waiver.

The above features are in accordance to the SAC resolution on the Shariah-compliant of preference shares.

4.3. Financial Impact of ICPS-i

This section will conduct a comprehensive examination of ICPS-i's financial impact and performance through an in-depth analysis of THHE Berhad's financial statements. The analysis will center on several key aspects, including the quantity of ordinary and preference shares, the company's profitability, the distribution of dividends, and the exercise of converting preference shares.

The following table summarises the financial performance of THHE Berhad from 2015 -to 2020. The period was selected as is the tenure of maturity of ICPS-i for 5 years period beginning in 2015.

	RM	RM	RM	RM	RM	RM
Year	2015	2016	2017	2018	2019	2020
Ordinary Shares	280,269,297	280,269,297	280,309,472	280,318,147	375,353,434	650,297,957
ICPS-i	275,000,000	275,000,000	274,959,825	274,951,150	274,944,523	-
(Loss) /Profit	(54,323,864)	(439,640,514)	(119,918,149)	(139,903,770)	9,911,622	(60,354,114)
Dividend	Nil	Nil	Nil	Nil	Nil	Nil
Conversion	Nil	Nil	40,175	8675	6627	274,944,523

Table 5: Summary of Financial Performances of THHE Berhad 2015-2020

It is noted that no dividend was paid either to ordinary or preference shareholders. The dividend payment was not recommended by the Board of Directors due to the weak financial performance of the company during the period despite THHE managing to make some profit in 2019. This signifies that there is no profit guarantee to preference shareholders, and it is related directly to the performance of the company. There is the element of investment as per the features of the *Mushārah* contract.

4.4. Examination of ICPS-i THHE vis-à-vis Shariah Advisory Council of Securities Commission Malaysia Resolution on Shariah Compliant Preference Shares

The case of THHE's ICPS-i demonstrates how the structural design of Islamic preference shares can be aligned with the Shariah Advisory Council (SAC) resolutions while also achieving tangible financing objectives.

First, in relation to profit distribution, the ICPS-i tied dividends to realised profits and required declaration by the Board. This structure met SAC's requirement that dividends must be profit-contingent rather than guaranteed. From a performance perspective, however, THHE's weak profitability meant that dividend distributions were limited, illustrating that while the structure avoided the impermissibility of fixed returns, the equity-like risk exposure also translated into low immediate returns for investors.

Second, on the issue of capital guarantee, SAC prohibits mechanisms that protect investors from loss. The ICPS-i complied by making conversion into ordinary shares dependent on prevailing market value, leaving investors exposed to price fluctuations. This aligned with Shariah principles but also meant that investors shared in the company's financial volatility. In practice, the conversion feature helped reduce THHE's gearing by converting liabilities into equity, thereby improving balance sheet strength, though it diluted existing shareholders' positions.

Third, regarding priority in liquidation, the SAC (2022) distinguished between impermissible guarantees and permissible post-entitlement *tanāzul*. The ICPS-i adopted this mechanism, allowing the Board to act as *wakīl* on behalf of ordinary shareholders to execute waivers after entitlements crystallised. While this satisfied Shariah requirements, its financial impact was largely contingent on the company's solvency. In THHE's distressed condition, the liquidation priority offered little practical value, as asset recovery remained uncertain.

Finally, the overall financing performance of the ICPS-i indicates that the instrument provided THHE with critical capital to ease cash flow pressures and restructure debt, while maintaining Shariah compliance. However, the alignment with SAC principles—particularly profit-contingency and absence of guarantees—meant that investors bore significant risks in line with *mushārah* rules. This dual outcome underscores both the strength of the ICPS-i as a Shariah-compliant equity tool and the challenge of attracting investors when issuers face financial distress.

Table 6: summary of Examination

SAC Resolution Requirement	ICPS-i Feature (THHE)	Observed Financial Outcome
Profit distribution must be contingent on realised profits; no guaranteed dividends.	Dividends only payable from realised profits, subject to Board declaration; “expected rate” treated as indicative.	Limited or no dividends declared due to weak profitability; investors exposed to equity-like risk.
No capital guarantee; redemption/conversion must reflect market value or company performance.	Conversion into ordinary shares based on prevailing market price; no guaranteed capital repayment.	Helped reduce gearing by converting liabilities into equity, strengthening balance sheet; diluted existing shareholders; investors bore market risk.
Priority in liquidation only permissible through post-entitlement <i>tanāzul</i> ; no ex-ante guarantees.	Board empowered as <i>wakīl</i> to execute <i>tanāzul</i> on behalf of ordinary shareholders once entitlements crystallised.	Priority rights compliant in form, but provided little practical benefit under THHE’s distressed condition with limited recoverable assets.
Flexibility in features (redeemability, convertibility, participation) allowed if no guarantees embedded.	Convertible and irredeemable structure embedded within ICPS-i; no capital/profit guarantees.	Ensured Shariah compliance while allowing financial restructuring flexibility; however, investor appeal remained constrained by issuer’s poor financial performance.

5. Research Findings

5.1. *Fiqh Adaptation (Takyīf Fiqhī) of Preference Shares as Mushārah Instruments*

The research finds that the most viable *takyīf fiqhī* (legal adaptation) for Islamic Preference Shares (IPS) is through the contract of *mushārah*. Under this framing, preference shareholders are treated as partners who contribute capital and share profits based on realised outcomes rather than fixed entitlements. Profit distribution must comply with the principle of *al-ghunm bi al-ghurm* (gain is accompanied by liability) and *al-kharāj bi al-damān* (returns are justified only by assuming risk). Consequently, the SAC clarified that any “expected dividend rate” attached to preference shares is merely indicative and not binding. Dividends are declared only upon profit realisation and subject to the solvency requirements of Section 131 of the Companies Act 2016. This position removes any element of capital or profit guarantee, aligning preference shares with *mushārah* principles while preserving their commercial utility.

5.2. *Divergent Shariah Rulings on Preference Shares*

The study also reveals divergence among Shariah authorities. The IIFA-OIC and AAOIFI categorically prohibit preference shares, arguing that financial privileges such as fixed dividends, capital protection, or liquidation priority undermine the *pari passu* principles of *mushārah* and resemble debt-like obligations. By contrast, the SAC Malaysia has adopted a more accommodative approach. Its 1999 resolution permitted non-cumulative preference shares through *tanāzul* (waiver of rights), and its 2022 resolution expanded this framework by introducing conditional *hibah* (*hibah mu’allaqah*), and recognising the Board of Directors as *wakīl* to execute post-entitlement waivers on behalf of ordinary shareholders. The comparative analysis demonstrates that while Middle Eastern juristic bodies prioritise a strict substance-over-form approach, Malaysia’s SAC emphasises contractual structuring to reconcile Shariah principles with market realities.

5.3. *Operationalisation and Financial Impact of ICPS-i*

The case study of THHE’s ICPS-i issuance highlights the practical application of Shariah-compliant preference shares. Structurally, the ICPS-i complied with SAC requirements: dividends were profit-contingent and subject to Board declaration, conversion into ordinary shares occurred at prevailing market value, and liquidation priority was achieved through post-entitlement *tanāzul*. These features demonstrate adherence to *mushārah* parameters and SAC resolutions.

From a financial performance perspective, however, the ICPS-i illustrated the inherent equity-like risks of such instruments. No dividends were declared during the five-year tenure (2015–2020), even in 2019 when THHE recorded modest profits, as the Board opted not to distribute dividends. This outcome underscores that there was no capital or profit guarantee for preference shareholders. At the same time, the conversion of ICPS-i into ordinary shares significantly reduced the company’s gearing and improved balance sheet stability, though

it diluted existing shareholder equity. Thus, while the ICPS-i succeeded in easing THHE's financial distress and preserving Shariah compliance, it offered limited immediate returns to investors.

6. Conclusion

Based on the research findings, it is evident that preference shares cannot provide assurances of capital and profit guarantees due to the Companies Act (2016) prohibiting such guarantees. The matter of granting preferential treatment during dividend payouts and the dissolution of the company can be achieved through the waiver of rights, utilizing the concepts of "Tanazul" and "Hibah" as recommended by the Shariah Advisory Council (SAC). This mechanism is considered permissible, aligning with the prevailing consensus among the majority of scholars, who endorse the waiver of rights once the intended entitlements to be waived materialize.

The comparative review of Shariah resolutions reveals clear divergence. IIFA-OIC and AAOIFI reject preference shares outright on grounds that financial priority undermines the essence of partnership. In contrast, the SAC Malaysia adopts a more facilitative position, permitting preference shares under strict conditions. The SAC's resolutions in 1999 and 2022 have provided innovative mechanisms—particularly *post-entitlement tanazul*, conditional hibah, and the Board's role as *wakil*—to ensure compliance without compromising the commercial viability of preference shares.

Furthermore, a thorough examination of the ICPS-i case study issued by THHE Berhad reveals the practical dynamics of IPS. Structurally, the instrument adhered to SAC resolutions by ensuring profit-contingent dividends, market-based conversion, and liquidation priority via waiver rather than guarantee. Financially, however, the ICPS-i reflected the inherent risks of equity: no dividends were distributed during its tenure, and investor returns depended on company performance. While the conversion feature helped reduce gearing and stabilise THHE's capital structure, it also diluted existing shareholders.

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The Efficacy of the Black–Scholes Option Pricing Model in Valuing Nifty 50 Single Stock Options: Is There a Difference Between Shariah-Compliant and Non-Compliant Constituent Stocks?

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Abstract

This study investigates the pricing efficacy of single-stock options on India's NIFTY 50 index by applying the Black–Scholes Option Pricing Model (BSOPM) to both call and put options from December 18, 2024–January 30, 2025. Theoretical prices were estimated using standard inputs (spot, strike, volatility, time to maturity, and a 5.98 % risk-free rate), and mispricing was defined as the difference between market prices and theoretical prices. Paired t-tests and Welch's tests compared overall mispricing and segmental differences between Shariah-compliant and conventional stocks. The findings revealed widespread mispricing: 46.9% of call options and 57.14% of put options exhibit significant underpricing relative to theoretical values. However, contrary to expectations that Shariah-compliant stocks might display different pricing behaviour due to structural characteristics like lower leverage and volatility, no statistically significant difference in mispricing was observed between Shariah-compliant and conventional options. These results suggest that broader market factors—such as liquidity, risk aversion, and regulatory dynamics—play a more dominant role in influencing pricing inefficiencies than the Shariah compliance of the underlying stocks. These insights can guide hedging strategies for institutional investors and inform regulatory oversight in emerging derivatives markets.

Keywords: Option pricing, Black–Scholes Model, Mispricing, Shariah-compliant stocks, Market inefficiencies

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1. Introduction

Although the Black–Scholes option-pricing model (BSOPM) serves as a basis for global derivatives markets with respect to its closed-form valuation and analytical simplicity, its application to India's structurally changed and increasingly retail-based derivatives market is lesser studied, especially when comparing Shariah-compliant and conventional single-stock options. Studies of NIFTY index and single-stock options point to significant BSOPM mispricing in that in-the-money contracts are under-priced, and out-of-the-money contracts are over-priced due to BSOPM's assumptions of constant volatility, frictionless trading, and continuous hedging (Tripathi & Gupta, 2010; Srivastava & Shastri, 2018). However, no research has explored whether the Shariah

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screening process that creates a subset that possesses lower leverage and different volatility features has an impact on BSOPM valuation performance on the single-stock options.

India's exchange-traded derivatives ecosystem re-emerged in mid-2000 under Securities and Exchange Board of India (SEBI) oversight, with index futures debuting in June and single-stock options following quickly (Sharma & Arora, 2015). Since then, derivatives volumes have outstripped those of the cash equity market, reflecting fast-evolving investor sophistication and growing demand for tailored hedging instruments. Notably, retail investors now account for 41 percent of India's overall derivatives trading volumes—up from just 2 percent in 2018—underscoring the segment's retail-driven dynamics (Dugal, 2024).

At the heart of India's equity-derivatives trading is the NIFTY 50 index—a free-float, market-capitalization-weighted basket of the fifty most liquid stocks. NSE Indices Limited launched the NIFTY 50 Shariah Index, whose constituents are drawn from the parent NIFTY 50 but must pass Shariah-compliance filters. These filters are overseen by Taqwaa Advisory & Shariah Investment Solutions (TASIS), which applies a two-stage screening: (1) a business-activity screen excluding firms in non-permissible industries (interest-based finance, alcohol, gambling, etc.); and (2) a financial-ratio screen capping interest-bearing debt, interest income, and cash-and-receivables exposures to ensure alignment with Islamic-finance principles (Natarajan & Dharani, 2012). This process yields a Shariah-compliant subset whose sectoral mix, leverage profile, and realized volatility differ meaningfully from the full NIFTY 50 universe.

Despite these structural and behavioural differences, three critical questions remain unanswered for NIFTY 50 single-stock options. First, how closely do BSOPM theoretical prices align with observed market premiums for calls and puts over a targeted 30-trading-day window (December 18, 2024–January 30, 2025)? We select this period to capture both year-end rebalancing dynamics and January's post-holiday trading surge while avoiding major Security and Exchange Board of India (SEBI) policy shifts. Second, do pricing deviations differ systematically between call and put contracts, reflecting asymmetries in hedging demand or embedded risk premia? Third, does Shariah compliance itself—beyond its influence on volatility and leverage—produce statistically distinct mispricing compared to non-compliant constituents.

To answer these questions, we (i) compute BSOPM theoretical values using spot prices, strikes, time to maturity, a prevailing risk-free rate, and historical volatility (30-day rolling standard deviation); (ii) define mispricing as the difference between observed option premiums and BSOPM estimates; and (iii) employ paired t-tests and Welch's tests — to examine mean deviations, call–put asymmetries, and cross-group differences.

By empirically quantifying BSOPM's valuation errors and isolating the effect of Shariah screening, our study makes three contributions. First, it provides one of the first rigorous, short-window tests of BSOPM efficacy in India's single-stock options market. Second, it uncovers whether call–put mispricing asymmetries persist when calibrated with market-consistent inputs. Third, it delivers the inaugural comparison of BSOPM mispricing between Shariah-compliant and non-compliant NIFTY 50 stocks—offering novel insights for both conventional and Islamic-finance practitioners. These results will guide institutional hedgers on model calibration and inform regulators as India's derivatives landscape continues to evolve.

2. Literature Review

The Black–Scholes model, despite criticisms in emerging markets for its assumptions of frictionless trading, continuous hedging, and log-normal returns, continues to serve as the benchmark for option valuation. In this study, its use is particularly justified because it provides a standardized baseline against which deviations can be measured. By comparing mispricing patterns across Shariah-compliant stock options and non-Shariah compliant stock options using the same pricing framework, we are able to isolate whether compliance screening introduces systematic differences in option valuation. However, empirical studies consistently highlight mispricing, particularly in emerging markets such as India, where high retail participation and episodic volatility shocks challenge the model's core assumptions. This literature review critically examines BSOPM's performance in Indian derivatives markets, focusing on single-stock options, and the underexplored impact of Shariah compliance on pricing efficiency.

The BSOPM, introduced by Black and Scholes (1973), provides a closed-form solution for pricing European-style options by linking market prices to five key inputs: spot price, strike price, time to maturity, risk-free rate, and volatility. While widely adopted, empirical research has sought to refine its assumptions. Merton (1976) introduced a jump–diffusion model, recognizing that discrete price movements better capture market shocks. Corrado and Su (1996) incorporated skewness and kurtosis adjustments to account for observed

fat-tailed distributions, while [Hull and White \(1987\)](#) developed stochastic volatility models to address BSOPM's assumption of constant variance. These refinements, while theoretically robust, reveal that pricing discrepancies persist due to liquidity constraints and investor behaviour.

Empirical studies on NIFTY index options document systematic mispricing. [Tripathi and Gupta \(2010\)](#) observed that in-the-money (ITM) calls are consistently underpriced, whereas out-of-the-money (OTM) contracts are overpriced, attributed to India's pronounced volatility smile. [Singh et al. \(2011\)](#) compared BSOPM valuations with those from a Heston–Nandi GARCH model, demonstrating that while GARCH frameworks improve accuracy, significant pricing errors remain. These biases are exacerbated by retail-driven demand dynamics, liquidity constraints, and regulatory inefficiencies, necessitating further scrutiny of single-stock options.

Empirical analyses of Indian single-stock options reinforce these findings. [Kumar and Agrawal \(2017\)](#) confirmed that BSOPM systematically underprices high-volatility stocks, failing to adjust for idiosyncratic risk. [Srivastava and Shastri \(2018\)](#) demonstrated that mispricing magnitudes increase with extreme moneyness, particularly for deep ITM and OTM contracts. [Sharma \(2018\)](#) highlighted that short-tenor options (maturities <30 days) exhibit greater discrepancies, underscoring BSOPM's limitations in handling short-term market dynamics. However, sector-specific stability plays a role in dampening pricing errors. [Panduranga \(2013\)](#) found that cement-sector options showed more modest mispricing, while [Narayanamoorthy and Sehgal \(2007\)](#) linked pricing efficiency to historical volatility patterns, demonstrating that implied volatility often underestimates actual risk.

Volatility estimation critically influences theoretical valuations. [Nagendran and Venkateswar \(2014\)](#) and [Nandan and Agrawal \(2016\)](#) showed that implied volatility improves pricing accuracy, yet historical volatility remains widely used due to data consistency and its independence from market calibration. This study adopts 30-day historical volatility, recognizing its comparability with prior Indian BSOPM studies ([Tripathi and Gupta, 2010](#); [Srivastava and Shastri, 2018](#)) while acknowledging potential robustness concerns.

Indian Shariah-screened equities exhibit lower and more predictable volatility, raising questions about their impact on option pricing. [Natarajan and Dharani \(2012\)](#) reported that while mean returns of Shariah-compliant stocks were similar to conventional equities, volatility was significantly lower, suggesting a distinct risk profile. [Dharani et al. \(2015\)](#) applied ARCH–GARCH models to Shariah-compliant stocks, confirming stable conditional variances relative to non-screened firms. Given BSOPM's sensitivity to volatility inputs, Shariah-compliant stocks should theoretically exhibit less mispricing, yet empirical validation remains scarce. The evidence is clear: BSOPM mispricing in India is widespread, influenced by violated assumptions of constant volatility, liquidity constraints, and retail-driven demand patterns. While sectoral stability and alternative pricing models offer partial corrections, mispricing remains persistent. The role of Shariah compliance in single-stock option valuation, despite theoretical predictions of lower volatility-driven biases, remains underexplored. By directly testing BSOPM-derived theoretical prices against observed market premiums, this study aims to address this critical research gap, providing insights for asset managers, traders, and regulators in both conventional and Islamic finance.

3. Research Methodology

This section presents a step-by-step account of the procedures used to evaluate option-pricing efficiency for NIFTY 50 single-stock options over the 30-trading-day window from 18 December 2024 to 30 January 2025. Although the index comprises 50 constituents, the analysis is restricted to 49 stocks: Shriram Finance was excluded because it executed a stock split on 10 January which is the observation period and reliable split-adjusted data were not available. The exclusion prevents mis-measurement of underlying prices and strike adjustments that would otherwise bias both Black–Scholes parameter estimates and subsequent efficiency tests. All remaining stages—data acquisition and cleaning, volatility and risk-free-rate estimation, theoretical pricing via the BSOPM, and statistical evaluation of pricing deviations—are detailed below to ensure transparency and reproducibility.

3.1 Data Collection

The sample for this study comprises forty-nine constituent stocks of the NIFTY 50 index, one having been excluded due to a recent corporate action that rendered its option series incomplete. Of these, eighteen have been classified as Shariah-compliant according to the National Stock Exchange's (NSE) screening criteria and

thirty-one as non-compliant. Daily closing equity prices were obtained for each of the forty-nine stocks over the thirty-trading-day period from 18 December 2024 to 30 January 2025 using the Python yahoo finance library; these price series were then exported in CSV format for analysis. For the same sample window, the full option chain for each underlying was retrieved directly from the NSE website. An option chain—in this context—is defined as the complete set of exchange-traded call and put contracts on a given underlying for every available strike and expiration, accompanied by each contract’s end-of-day premium, open interest, and trading volume. A constant annualized risk-free rate of 5.98 percent (0.0598 in decimal form), corresponding to the prevailing 90-day Treasury bill bid rate published by the Reserve Bank of India, was applied uniformly in all theoretical valuations. The procedure for calculating historical volatility is detailed in Section 8.3. Collectively, these equity, derivatives, and risk-free rate inputs form a comprehensive and reliable foundation for calibrating and evaluating the Black–Scholes Option Pricing Model.

3.2 Data Cleaning and Exclusion Criteria

Once acquired, the raw equity series were adjusted in Excel for corporate actions. Adjustment factors for dividends, bonus issues, and splits were applied and documented in a dedicated worksheet. Sriram Finance, which underwent a 1 : 5 shares split on 10 January 2025 without a reliable adjusted price history, was therefore excluded, yielding a final sample of forty-nine stocks. Option-chain data were subjected to a completeness screen: any strike price missing one or more premium quotes across the thirty-day period was removed. This ensured that all subsequent computations relied on consistently observed option contracts.

3.3 Strike Price Identification

Strike-selection was informed by robust evidence that BSOPM mispricing in India escalates as options move away from the at-the-money level. [Tripathi and Gupta \(2010\)](#) show that in-the-money call options on the NIFTY index are persistently underpriced, while out-of-the-money contracts are consistently overpriced—patterns attributable to a pronounced volatility smile at moneyness extremes. [Srivastava and Shastri \(2018\)](#) further demonstrate that relative pricing discrepancies increase monotonically with the distance from the at the money (ATM) strike, peaking for deep ITM and deep OTM strikes. In light of these findings, and to focus our analysis on the strike region where hedging demand is highest and theoretical-market comparability is strongest, we adopt a proximity-based approach to ATM identification.

Concretely, we compute each stock’s thirty-day average closing price over the 18 December 2024–30 January 2025 window in Excel. An option contract whose strike exactly equals this average—and which possessed uninterrupted daily data—was designated as the ATM strike (applicable to Coal India, HCL Technologies, IndusInd Bank, Maruti Suzuki, Nestlé India, and Power Grid Corporation of India). For the remaining stocks, we selected the nearest available strike within ± 1 percent of the average; only Hero MotoCorp and Tata Steel required expansion of the tolerance to ± 2 percent to secure a consistently traded series. This hierarchical, literature-motivated method ensures that our selected strikes lie closest to true ATM levels—precisely where BSOPM’s assumptions are most pertinent—while guaranteeing uniform data coverage across the entire sample.

Table 1 – Strike Prices.

	Company Name	Avg near ATM Strike Price (₹)	CE	PE	± 1 range		CE	PE	±2 (for illiquid options)		CE	PE	Selected Strike Price (₹)
1	Adani Enterprises	2410	x	x	2386	2434	✓	✓	2362	2458			2400
2	Adani Ports	1152	x	x	1140	1164	✓	✓	1129	1175			1140
3	Apollo Hospitals [S]	7040	x	x	6970	7110	✓	✓	6899	7181			7000
4	Asian Paints [S]	2276	x	x	2253	2299	✓	✓	2230	2322			2280
5	Axis Bank	1035	x	x	1025	1045	✓	✓	1014	1056			1030
6	Bajaj Auto	8691	x	x	8605	8778	✓	✓	8518	8865			8700

7	Bajaj Finserv	1670	x	x	1653	1687	✓	✓	1637	1703			1680
8	Bajaj Finance	7230	x	x	7158	7302	✓	✓	7085	7375			7200
9	BEL	279	x	x	276	282	✓	✓	273	285			280
10	Bharti Airtel	1607	x	x	1591	1623	✓	✓	1575	1639			1600
11	BPCL [S]	274	x	x	271	277	✓	✓	269	279			275
12	Britannia Industries [S]	4879	x	x	4830	4928	✓	✓	4781	4976			4850
13	Cipla [S]	1470	x	x	1455	1484	✓	✓	1440	1499			1480
14	Coal India [S]	375	✓	✓	372	379			368	383			375
15	Dr. Reddy's Laboratories [S]	1318	x	x	1305	1331	✓	✓	1292	1344			1320
16	Eicher Motors	5024	x	x	4974	5074	✓	✓	4924	5125			5000
17	Grasim Industries	2437	x	x	2412	2461	✓	✓	2388	2486			2440
18	HCL Tech [S]	1860	✓	✓	1841	1878			1823	1897			1860
19	HDFC Bank	1708	x	x	1690	1725	✓	✓	1673	1742			1710
20	HDFC Life Insurance Company	619	x	x	613	626	✓	✓	607	632			620
21	Hero MotoCorp [S]	4055	x	x	4014	4095	x	x	3974	4136	✓	✓	4000
22	Hindalco Industries	601	x	x	595	607	✓	✓	589	613			600
23	Hindustan Unilever [S]	2368	x	x	2344	2392	✓	✓	2321	2415			2360
24	ICICI Bank	1257	x	x	1244	1270	✓	✓	1232	1282			1260
25	IndusInd Bank	960	✓	✓	950	970			941	979			960
26	Infosys	1899	x	x	1880	1918	✓	✓	1861	1937			1900
27	ITC	446	x	x	442	450	✓	✓	437	455			445
28	JSW Steel	914	x	x	905	923	✓	✓	896	932			910
29	Kotak Mahindra Bank	1810	x	x	1792	1828	✓	✓	1774	1846			1800
30	Larsen & Toubro	3562	x	x	3526	3598	✓	✓	3491	3633			3550
31	Mahindra & Mahindra	2984	x	x	2954	3014	✓	✓	2924	3044			3000
32	Maruti Suzuki India	11600	✓	✓	11484	11716			11368	11832			11600
33	Nestle India [S]	2180	✓	✓	2158	2201			2136	2223			2180
34	NTPC	324	x	x	321	327	✓	✓	317	330			325
35	ONGC [S]	248	x	x	246	250	✓	✓	243	253			250
36	Power Grid Corporation of India	300	✓	✓	297	303			294	306			300
37	Reliance Industries	1243	x	x	1231	1255	✓	✓	1218	1268			1240
38	SBI Life Insurance Company	1443	x	x	1429	1457	✓	✓	1414	1472			1440
39	State Bank of India	775	x	x	767	783	✓	✓	760	791			770
40	Sun Pharmaceutical Industries [S]	1799	x	x	1781	1817	✓	✓	1763	1835			1800

41	Tata Consumer Products [S]	945	x	x	935	954	✓	✓	926	963			940
42	Tata Motors	754	x	x	746	761	✓	✓	739	769			750
43	Tata Steel	133	x	x	132	134	x	x	130	136	✓	✓	130
44	TCS [S]	4136	x	x	4094	4177	✓	✓	4053	4218			4150
45	Tech Mahindra [S]	1688	x	x	1671	1704	✓	✓	1654	1721			1700
46	Titan	3369	x	x	3335	3403	✓	✓	3302	3436			3350
47	Trent [S]	6449	x	x	6384	6513	✓	✓	6320	6578			6400
48	UltraTech Cement [S]	11210	x	x	11098	11322	✓	✓	10986	11435			11200
49	Wipro	297	x	x	294	299	✓	✓	291	302			295

Source: Author’s computation using NSE data

This table displays the strike prices for call (CE) and put (PE) options associated with the NIFTY 50 constituent stocks, along with designated ranges for liquid and illiquid options. It serves as a reference for determining the optimal strike price for options trading based on liquidity considerations. Stocks marked with ‘[S]’ indicate Shariah-compliant equities.

3.4 Parameter Estimation for Black–Scholes Inputs

The Black–Scholes formula requires five inputs: the spot price (S), the strike price (K), time to expiry (t), the risk-free rate (r), and volatility (σ) each of which was estimated as follows.

Option-chain selection was governed by liquidity considerations: only the 30 January 2025 expiration series traded continuously at the pre-selected at-the-money strikes; all other expiries either failed to trade on certain days or exhibited inadequate volume. Accordingly, daily call and put premiums, open interest, and trading volumes for the 30 January 2025 contracts were retrieved from the National Stock Exchange website over the valuation window (18 December 2024–30 January 2025).

Spot prices were taken from the cleaned series of daily closing equity prices. Strike prices were held constant at the pre-selected at-the-money levels shown in Table 8.1. Time to expiry was expressed as the ratio of remaining trading days in the valuation window (18 December 2024–30 January 2025) to the conventional 252-day trading year. A uniform annualized risk-free rate of 5.98 percent ($r = 0.0598$) was applied across all observations.

Historical volatility was estimated over a separate thirty-trading-day period immediately preceding this window (1 November 2024 to 17 December 2024). Within the estimation period, daily closing prices were used to compute thirty logarithmic returns in Excel, $\ln(S_t/S_{t-1})$, where S_t denotes the closing price on day t, then calculating their standard deviation using Excel’s STDEV.P function. This daily figure was annualized by multiplying by square root of 252 producing the annualized volatility input (σ_{annual}) for the Black–Scholes model. The annualized volatility values for all forty-nine constituent stocks, including both Shariah-compliant (denoted as ‘[S]’) and non-Shariah-compliant equities, are presented in Table 2.

Table 2 Annualized Volatility Estimates for Constituent Stocks.

Stock Name	Volatility
Adani Enterprises	0.8598
Adani Ports	0.5679
Apollo Hospitals [S]	0.3041
Asian Paints [S]	0.2981
Axis Bank	0.1863
Bajaj Auto	0.2450
Bajaj Finserv	0.1946
Bajaj Finance	0.2209
BEL	0.2867
Bharti Airtel	0.2680
BPCL [S]	0.2526
Britannia Industries [S]	0.3221

Cipla [S]	0.2025
Coal India [S]	0.1959
Dr. Reddy's Laboratories [S]	0.2065
Eicher Motors	0.2759
Grasim Industries	0.2558
HCL Technologies [S]	0.1986
HDFC Bank	0.1962
HDFC Life Insurance Company	0.2071
Hero MotoCorp [S]	0.2564
Hindalco Industries	0.3596
Hindustan Unilever [S]	0.2132
ICICI Bank	0.1577
IndusInd Bank	0.1871
Infosys	0.2459
ITC	0.1719
JSW Steel	0.2682
Kotak Mahindra Bank	0.1581
Larsen & Toubro	0.2316
Mahindra & Mahindra	0.2702
Maruti Suzuki India	0.1678
Nestle India [S]	0.1677
NTPC	0.2545
ONGC [S]	0.2375
Power Grid Corporation of India	0.2533
Reliance Industries	0.2249
SBI Life Insurance Company	0.2330
State Bank of India	0.2579
Sun Pharmaceutical Industries [S]	0.1848
Tata Consumer Products [S]	0.2497
Tata Motors	0.2267
Tata Steel	0.2335
TCS [S]	0.2441
Tech Mahindra [S]	0.2328
Titan	0.2368
Trent [S]	0.3184
UltraTech Cement [S]	0.2548
Wipro	0.2165

Source: Author's computation using NSE data

3.5 Theoretical Option-Price Computation

With inputs in place, theoretical call and put prices were calculated using the Black–Scholes framework in Excel. The intermediate terms were evaluated via Excel's natural-log and arithmetic functions.

$$d1 = \frac{\ln S/K + (r + \sigma^2/2)t}{\sigma \sqrt{t}}$$

$$d2 = d1 - \sigma \sqrt{t}$$

Subsequently, call prices (CE) were obtained using

$$C = S \cdot N(d1) - Ke^{-rt} \cdot N(d2)$$

$$P = Ke^{-rt} \cdot N(d2) - S \cdot N(d1)$$

These formulas were applied uniformly across all forty-nine stocks and thirty trading days, yielding a total of 2,998 option-price observations.

3.6 Empirical Measurements and Statistical Tests

Following the computation of Black–Scholes theoretical prices for all 2,998 option observations, the dataset was divided by underlying stock and option type, yielding thirty paired observations for calls and thirty for puts per security. Paired-sample t-tests were then performed in Excel to compare each series of market premiums against its corresponding model prices. For each of the forty-nine stocks, paired-sample t-tests were conducted separately on the deviations of call and put prices. For each test, Excel produced the sample means market price and mean theoretical price, together with the t-statistic and associated p-value. Instances in which the p-value fell below the 0.05 threshold were interpreted as evidence of statistically significant discrepancies between the market prices and the theoretical prices as calculated by BSOPM. To quantify these deviations, the percentage mispricing was calculated as;

$$\text{Mispricing(\%)} = (\text{Market Price} - \text{Theoretical Price} / \text{Theoretical Price}) \times 100$$

The resulting t-statistics, p-values and percentage mispricing were recorded in tabular form, providing a clear, stock-by-stock measure of both the significance and magnitude of systematic mispricing under the Black–Scholes framework. To ensure these results were free from spreadsheet-related errors, all paired-sample t-tests were independently replicated in Python. The Python outputs matched the Excel results exactly, confirming the reliability of our inferential statistics.

All statistical tests were evaluated at the conventional 5% significance level, such that $p < 0.05$ was taken as grounds to reject the null hypothesis of equality between market and theoretical prices. This threshold reflects common practice in empirical finance research, providing robustness while avoiding over-interpretation of marginal results.

Having established the overall significance of mispricing at the stock level, we next examined whether Shariah-compliant Nifty 50 constituents display distinct option-pricing mispricing compared to their non-compliant counterparts, we computed, for each of the 49 equities and for both call (CE) and put (PE) series, the average mispricing $\Delta = (\text{Market} - \text{BSOPM})$. This resulted in 98 observations, each marked with a binary "Compliance" indicator (Yes = Shariah-compliant, No = non-compliant). We then compared the distribution of average mispricing Δ across the two groups employing an independent-samples t-test with Welch's correction, suitable for uneven variances and sample sizes. The null hypothesis (H_0) posited that the mean average mispricing Δ for Shariah-compliant options is equivalent to the mean.

3.7 Concluding remarks in methodology

This chapter has comprehensively outlined the empirical framework, encompassing data collection, cleaning, strike identification, parameter estimation, and theoretical pricing under the Black–Scholes model, followed by inferential procedures using paired-sample t-tests. Each step was documented to ensure reproducibility and to directly address the study's hypotheses concerning overall mispricing and the potential influence of Shariah compliance. Having established this methodological foundation, the analysis now turns to the presentation and interpretation of the empirical findings.

4. Results

This section presents an in-depth interpretation of the empirical findings for Objective 2, which measures the average difference ($\Delta = \text{Market Price} - \text{BSOPM price}$) for call and put options on all 49 Nifty 50 stocks, testing whether these deviations differ significantly. The results reveal three clear clusters of behavior for calls and put: (1) statistically significant overvaluation, (2) statistically insignificant deviation, and (3) statistically significant undervaluation.

4.1 Call Options: Overvaluation, Indeterminate, and Undervaluation

The findings of the study reveal significant deviations in call-option pricing for selected stocks relative to the theoretical pricings provided by the Black-Scholes Option Pricing Model (BSOPM). Notably, seven stocks as shown in Table 3, exhibited statistically significant overvaluation ($\Delta > 0$, $p < 0.05$), wherein market prices consistently exceeded theoretical prices. Out of the seven stocks, Coal India is the only shariah compliant stocks, that exhibit statistically significant call option overvaluation.

The evaluation of call option pricing among banking stocks within the NIFTY50 Index reveals notable mispricing dynamics. Specifically, out of the six banking stocks constituting the index, the call options of four exhibited overvaluation, where the market price (M_p) exceeded the theoretical price (T_p). This discrepancy underscores potential inefficiencies in option pricing models. Moreover, among the seven stocks analyzed, Coal India, a Shariah-compliant stock, demonstrated statistically significant call option overvaluation, suggesting that compliance with Islamic financial principles does not insulate a stock from prevailing market inefficiencies. The extent of percentage mispricing varied substantially across the sample, ranging from a relatively modest 2% for Tata Steel to a pronounced 32% for Axis Bank. Such disparities indicate that market participants may be attributing varying degrees of premium over Black-Scholes Option Pricing Model (BSOPM)-derived valuations.

Table 3 Stocks with Statistically Significant Call-Option Overvaluation ($M_p > T_p$).

Stock	Mean Market Price (₹)	Mean Theoretical Price (₹)	% Mispricing	p value
AXISBANK	52.095	39.563	31.68%	0.003
COALINDIA [S]	16.572	13.454	23.17%	0.034
ICICIBANK	33.007	29.634	11.38%	< 0.001
INDUSINDBK	30.567	24.256	26.02%	< 0.001
KOTAKBANK	53.025	49.875	6.32%	0.006
TATAMOTORS	28.410	25.933	9.55%	< 0.001
TATASTEEL	6.480	6.351	2.03%	0.004

(Source: Author's computation using NSE data)

In contrast, nineteen stocks demonstrated no statistically significant deviation from theoretical prices (Δ not significant at $p < 0.05$), indicating a close alignment between observed market premiums and BSOPM prices. Among the five Fast-Moving Consumer Goods (FMCG) stocks that are part of the NIFTY50 Index, four—ITC, Hindustan Unilever (HUL), Nestle India, and Britannia—demonstrate statistical significance. Additionally, eight Shariah-compliant stocks, identified in Table 4 by [S], do not exhibit statistical significance. This trend highlights the distinct pricing behavior and market characteristics of these stock categories, potentially influenced by factors such as liquidity, investor sentiment, and sector-specific dynamics.

Table 4 Stocks with Statistically no Significant deviation for Call Option Pricing.

Stock	Mean Market Price (₹)	Mean Theoretical Price (₹)	% Mispricing	p value
BAJAJ-AUTO	263.13	274.49	-4.14%	0.170
BAJAJFINSV	41.22	42.45	-2.90%	0.135
BEL	11.91	12.17	-2.17%	0.514
BPCL[S]	14.04	13.31	5.47%	0.112
BRITANNIA [S]	124.11	117.69	5.45%	0.154
CIPLA [S]	37.18	36.96	0.61%	0.818
DRREDDY [S]	43.87	43.56	0.71%	0.830
GRASIM	84.44	81.20	4.00%	0.746
HDFCBANK	51.85	51.91	-0.11%	0.975
HDFCLIFE	15.35	16.73	-8.25%	0.053
HINDUNILVR [S]	61.23	66.27	-7.62%	0.399

ITC	16.54	18.12	-8.70%	0.185
JSWSTEEL	33.56	32.24	4.07%	0.569
MARUTI	292.61	311.04	-5.93%	0.064
NESTLEIND [S]	52.17	54.74	-4.69%	0.460
NTPC	13.78	11.87	16.02%	0.274
TRENT [S]	418.98	431.26	-2.85%	0.207
ULTRACEMCO [S]	373.82	402.94	-7.23%	0.110
WIPRO	14.03	13.16	6.67%	0.064

(Source: Author's computation using NSE data)

Furthermore, analysis indicates that the remaining 23 stocks exhibit significant undervaluation ($\Delta < 0$, $p < 0.05$), with market prices below their theoretical prices. Within the Information Technology sector of the NIFTY50 Index, which comprises five stocks, four—HCL Tech, Infosys, TCS, and Tech Mahindra—demonstrate statistically significant call option undervaluation. Additionally, nine Shariah-compliant stocks, listed in Table 5 by [S], show differences between their market and theoretical prices, indicating that their call options are undervalued. This suggests possible market inefficiencies, which may be influenced by sector trends and investor behavior. Further research is needed to understand the reasons behind this undervaluation.

Table 5 Stocks with Statistically Significant Call-Option Undervaluation ($M_p < T_p$).

Stock	Mean Market Price (₹)	Mean Theoretical Price (₹)	% Mispricing	p value
ADANIENIT	107.942	256.537	-57.92%	8E-14
ADANIPTS	57.332	87.320	-34.34%	5E-12
APOLLOHOSP [S]	242.291	325.559	-25.58%	2E-10
ASIANPAINT [S]	53.063	82.391	-35.60%	4E-13
BAJFINANCE	210.312	222.307	-5.40%	0.0146
BHARTIARTL	38.562	55.985	-31.12%	5E-13
EICHERMOT	136.607	184.070	-25.79%	1E-12
HCLTECH [S]	58.015	67.806	-14.44%	9E-05
HEROMOTOCO [S]	219.693	232.080	-5.34%	0.0033
HINDALCO	18.895	27.962	-32.43%	3E-13
INFY	56.273	62.957	-10.62%	0.0002
LT	106.052	120.999	-12.35%	1E-06
M&M	89.542	104.040	-13.94%	2E-06
ONGC [S]	9.462	10.222	-7.44%	3E-06
POWERGRID	10.923	12.481	-12.48%	8E-09
RELIANCE	30.413	37.209	-18.26%	3E-11
SBILIFE	39.983	46.130	-13.32%	2E-07
SBIN	26.730	31.255	-14.48%	6E-10
SUNPHARMA [S]	47.597	53.557	-11.13%	6E-08
TATACONSUM [S]	25.650	31.597	-18.82%	1E-08
TCS [S]	84.117	127.320	-33.93%	3E-10
TECHM [S]	42.997	46.458	-7.45%	0.0295
TITAN	91.260	110.510	-17.42%	5E-08

(Source: Author's computation using NSE data)

4.2 Put Options: Overvaluation, Indeterminate, and Undervaluation

The findings of the study reveal significant deviations in the put-option pricing for selected stocks relative to the theoretical pricings provided by the Black-Scholes Option Pricing Model (BSOPM). Notably, thirteen stocks exhibited statistically significant overvaluation ($\Delta > 0$, $p < 0.05$), wherein market prices consistently exceeded theoretical prices, indicating that traders pay an extra premium for bearish protection.

The percentage mispricing across these stocks varies between 6.23% (Cipla) and 41.62% (IndusInd Bank), indicating substantial deviations from theoretical valuations. Among these twelve stocks, six—Axis Bank, Coal India, ICICI Bank, IndusInd Bank, Kotak Mahindra Bank, Tata Motors, and Tata Steel—exhibited call option overvaluation, where market prices exceeded theoretical estimates.

Among the six banking stocks in the NIFTY50 Index, four show overvalued put options ($M_p > T_p$), reflecting the same trend as their call options. This points to persistent pricing inefficiencies in the banking sector. Additionally, six Shariah-compliant stocks, listed in Table 6 by [S], exhibit statistically significant put option overvaluation, reinforcing the presence of pricing anomalies. These trends call for further analysis of market sentiment, liquidity, and structural influences on option pricing.

Table 6 Stocks with Statistically Significant Put-Option Overvaluation ($M_p > T_p$).

Stock	Mean Market Price	Mean Theoretical Price	% Mispricing	p value
AXIS BANK	27.042	24.629	9.8%	0.0019
BPCL [S]	7.478	6.417	16.55%	0.0037
BRITANNIA [S]	93.662	74.480	25.75%	7E-10
CIPLA [S]	41.835	39.383	6.23%	0.007
COALINDIA [S]	6.542	5.068	29.08%	8E-07
DRREDDY [S]	40.498	37.166	8.97%	0.0026
HCLTECH [S]	51.783	46.099	12.33%	9E-06
ICICIBANK	27.832	23.818	16.85%	3E-09
INDUSINDBK	26.510	18.719	41.62%	1E-09
KOTAKBANK	38.815	34.207	13.47%	0.0004
TATAMOTORS	19.282	16.496	16.89%	1E-04
TATASTEEL	2.377	2.216	7.25%	0.0002
WIPRO	6.947	4.912	41.43%	3E-08

(Source: Author's computation using NSE data)

Eight stocks show non-significant differences, meaning the market and BSOPM prices are statistically indistinguishable. Among the eight stocks analyzed, six—Bajaj Auto, Bajaj Finserv, HDFC Life, ITC Ltd, Maruti Suzuki Ltd, and Nestlé India—demonstrate pricing efficiency, with no significant deviation in their call option prices as well. Similarly, Bajaj Auto, Bajaj Finance, and Bajaj Finserv, the only Bajaj Group companies in the NIFTY50 Index, show no statistically significant differences in their put option prices. This consistency may be attributed to shared financial strategies, market positioning, and institutional stability within the Bajaj Group. Additionally, two Shariah-compliant stocks, listed in Table 7 by [S], also display no statistically significant deviation, reinforcing broader trends in option pricing.

Table 7 Stocks with Statistically no Significant deviation for Put Option Pricing.

Stock	Mean Market Price	Mean Theoretical Price	% Mispricing	p value
BAJAJ-AUTO	232.232	231.7367	0.21%	0.9456
BAJAJFINSV	42.745	47.3004	-9.63%	0.0871
BAJFINANCE	179.570	191.7235	-6.34%	0.1939
HDFCLIFE	13.692	13.1671	3.98%	0.5028
ITC	5.955	6.2278	-4.38%	0.0573
MARUTI	292.783	273.1105	7.20%	0.1924
NESTLEIND [S]	30.595	31.0095	-1.34%	0.6887
TECHM [S]	48.463	45.3360	6.90%	0.0809

(Source: Author's computation using NSE data)

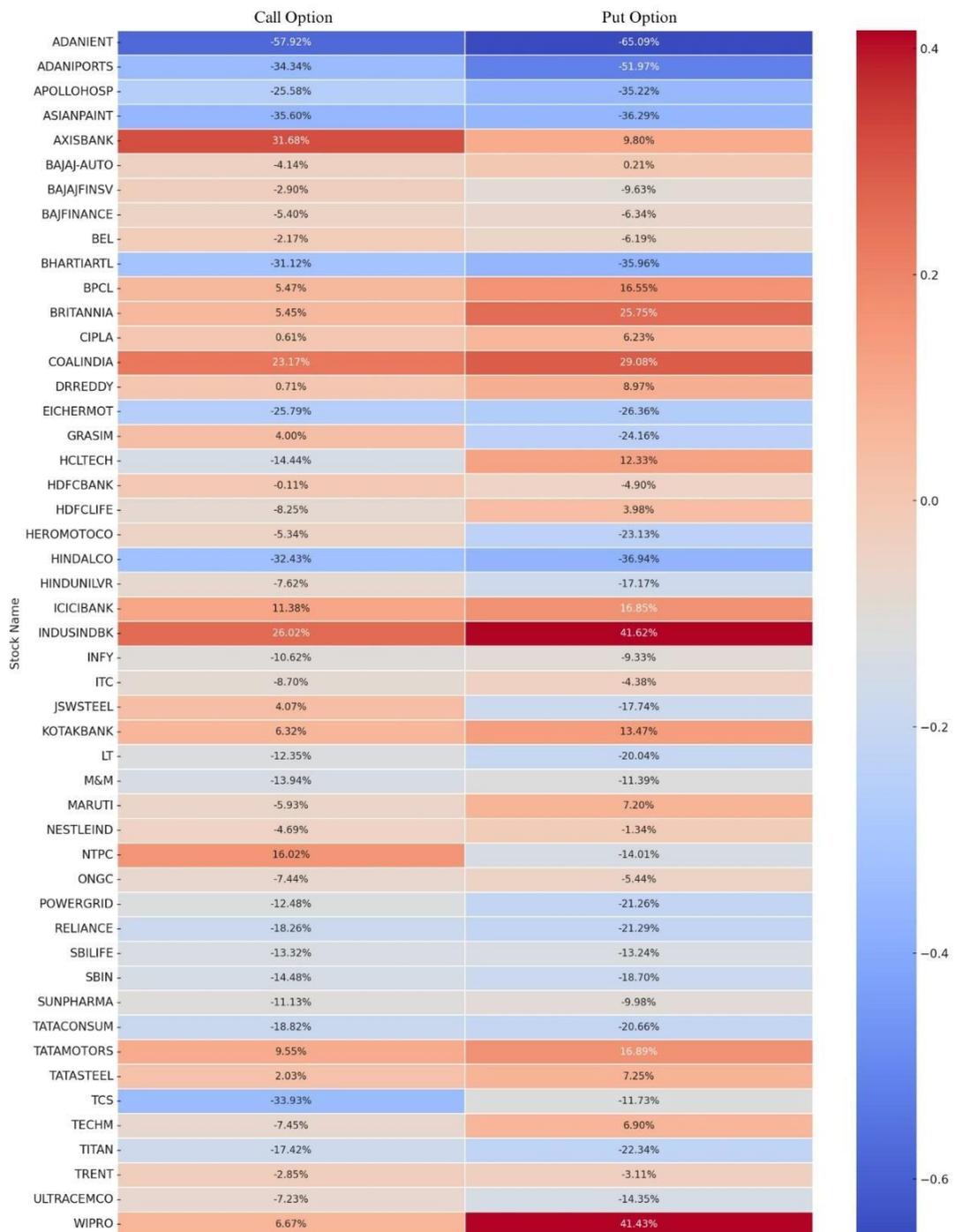
The remaining twenty-eight put series—comprising the bulk of the sample—display significant undervaluation of the market prices ($p < 0.05$). Additionally, ten Shariah-compliant stocks, listed in Table 8 by [S], also display statistically significant put option undervaluation.

Table 8 - Stocks with Statistically Significant Put-Option Undervaluation ($M_p < T_p$).

Stock	Mean Market Price	Mean Theoretical Price	% Mispricing	p value
ADANIENT	78.530	224.9522	-65%	1.2E-13
ADANIPTS	30.895	64.3233	-52%	1.6E-12
APOLLOHOSP [S]	138.895	214.4109	-35%	7.3E-11
ASIANPAINT [S]	45.260	71.0385	-36%	3.9E-15
BEL	8.368	8.9201	-6%	7.6E-03
BHARTIARTL	25.838	40.3503	-36%	8.1E-11
EICHERMOT	108.717	147.6274	-26%	7.5E-10
GRASIM	51.952	68.5013	-24%	2.2E-08
HDFCBANK	39.510	41.5453	-5%	1.7E-02
HEROMOTOCO [S]	37.075	48.2284	-23%	8.4E-10
HINDALCO	14.183	22.4933	-37%	1.6E-12
HINDUNILVR [S]	40.308	48.6655	-17%	1.1E-04
INFY	45.748	50.4561	-9%	2.7E-03
JSWSTEEL	19.223	23.3689	-18%	1.1E-05
LT	63.732	79.7060	-20%	7.7E-08
M&M	90.270	101.8773	-11%	1.8E-05
NTPC	7.048	8.1964	-14%	1.7E-05
ONGC [S]	5.760	6.0916	-5%	1.1E-02
POWERGRID	5.567	7.0697	-21%	1.7E-09
RELIANCE	21.743	27.6263	-21%	3.6E-09
SBILIFE	29.980	34.5552	-13%	9.9E-03
SBIN	15.418	18.9651	-19%	4.8E-06
SUNPHARMA [S]	29.540	32.8152	-10%	9.2E-06
TATACONSUM [S]	19.862	25.0332	-21%	2.8E-05
TCS [S]	94.005	106.4999	-12%	7.6E-05
TITAN	57.158	73.5969	-22%	7.2E-09
TRENT [S]	287.110	296.3195	-3%	1.1E-02
ULTRACEMCO [S]	274.973	321.0246	-14%	6.7E-05

(Source: Author's computation using NSE data)

Figure 1 Heatmap of % Mispricing



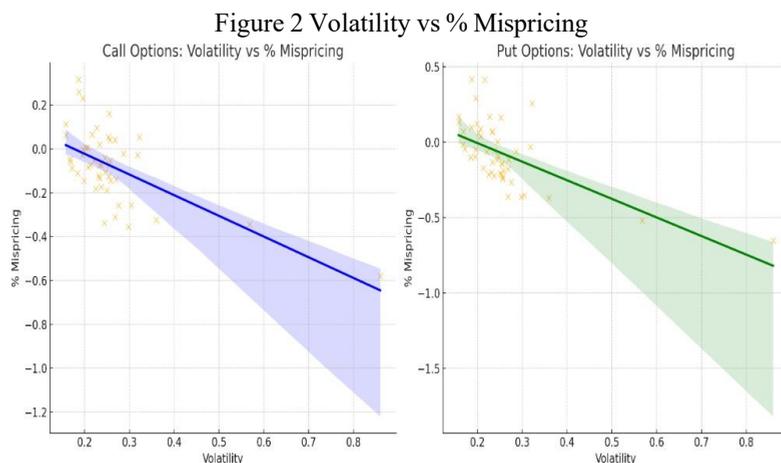
Heatmap of %Mispricing

(Source: Author’s computation using NSE data)

This heatmap illustrates the percentage mispricing of call (CE) and put (PE) options across the NIFTY50 constituent stocks. Each row represents a stock, with columns denoting call and put options. Positive values (red) indicate overvaluation, while negative values (blue) signal undervaluation.

4.3 Impact of Volatility on Option Mispricing: Empirical Analysis

The analysis reveals a strong negative correlation between volatility and option mispricing for both call and put options (-0.619 and -0.624, respectively). This finding indicates that increased stock volatility corresponds to reduced deviations from theoretical values derived from the Black-Scholes Option Pricing Model (BSOPM). More volatile stocks exhibit market prices that align more closely with BSOPM predictions, suggesting that the market effectively incorporates risk into pricing. In contrast, lower-volatility stocks demonstrate greater mispricing, particularly significant cases of overvaluation or undervaluation. These results underscore volatility as a critical factor in explaining deviations from theoretical option pricing and advocate for incorporating volatility adjustments in future mispricing models to enhance predictive accuracy.



(Source: Author's computation using NSE data)

4.4 Shariah Compliant vs Non shariah compliant

The comparative analysis of mispricing between Shariah-compliant and non-compliant NIFTY 50 options reveals that the two groups are indistinguishable in terms of average deviation from Black–Scholes theoretical values. The Welch t-test produced a test statistic of -0.1205 and a two-tailed p-value of 0.9044 , indicating that the observed mean difference of approximately 1.92% (-6.09% for Shariah-compliant versus -8% for non-compliant series) is not statistically significant at $p = 0.05$. Although the non-shariah compliant subset exhibits both a larger cross-sectional variance (768.62 versus 461.71) and a larger sample size, Welch's formulation adjusts for these disparities in dispersion and degrees of freedom ($df \approx 88$).

Collectively, the statistical and empirical evidence suggests that Shariah stock-screening criteria—primarily the removal of highly leveraged or interest-based companies do not result in a significant shift in the market pricing of individual stock options, thus the Null Hypothesis (H_0) is not rejected.

Among the 62 observations on non-Shariah-compliant stocks, 72.6% observations (45 observations) exhibit mispricing that is significant at the 5 percent level, while the remaining 27.4% observations (17 observations) fail to reject the null hypothesis of zero deviation. Likewise, in the sample of 36 Shariah-compliant stocks, 72.2% observations (26 observations) are significant, with 27.8% observations (10 observations) deemed insignificant.

Focusing first on call options in the non-Shariah compliant group, 20 of the 31 call observations (64.5%) display statistically significant mispricing. Within this subset, 30% (6 options) are overvalued, indicating market prices in excess of theoretical values, whereas 70% (14 options) are undervalued. The remaining 35.5% call observations (11 options) do not exhibit significant deviation.

Among the 36 observations on put options of non-Shariah-compliant group, higher share—25 out of 31 observations (80.6%)—is statistically significant. Of these, 28% are overvalued (7 options) are overvalued and 72% (18 options) are undervalued, leaving 19.4% (6 options) without significant mispricing.

In contrast, Shariah-compliant call options exhibit fewer significant departures: only 55.6% are significant, and within this group a striking 90% (9 calls) are undervalued, with a solitary case of overvaluation (10%). The 8 remaining calls (44.4%) do not depart significantly from theoretical values. This pronounced skew toward underpricing among Shariah calls may stem from the lower leverage ratios inherent to screened firms, which tend to dampen idiosyncratic volatility and yield market prices that systematically fall below Black–Scholes estimates.

Finally, Shariah-compliant put options display the highest significance rate of all subsamples: 88.9% are significant, and within this group 37.5% are overvalued (6 puts) and 62.5% undervalued (10 puts) observations; the remaining 11.1% (2 puts) are insignificant.

5. Discussion

Contrary to the prevailing evidence in the literature—where option markets are typically found to exhibit systematic overvaluation relative to Black–Scholes benchmarks—this study documents a different pattern: across the Nifty 50 universe, about 52 percent of options (both call and put) display statistically significant undervaluation, 27.5 percent show no significant difference, and the remaining 20.4 percent exhibit overvaluation. This divergence highlights that pricing dynamics in India’s derivatives market do not necessarily replicate those of developed economies, and that local structural and regulatory factors can generate distinct outcomes.

The observed persistent overvaluation of at-the-money (ATM) call options suggests that volatility clustering and liquidity constraints—factors not captured by the Black–Scholes assumptions of constant volatility and frictionless markets—play a significant role in pricing deviations (Hull and White, 1987). For Shariah-compliant stock options, the similarity in mispricing patterns indicates that screening criteria alone do not materially alter the violation of Black–Scholes assumptions; instead, market microstructure effects dominate. Thus, the Black–Scholes model serves not only as the pricing benchmark but also as the analytical bridge in comparing Shariah-compliant stock options and non-Shariah compliant stock options, since deviations from its assumptions manifest similarly across both categories.

Several contemporaneous market forces help explain why theoretical values systematically exceed observed premiums on both calls and puts during our sample period. First, by selecting strikes very close to at-the-money levels, this study concentrated on contracts where theoretical sensitivities peak and small input errors translate into large price gaps; prior studies that report market overvaluation typically examine a broader range of moneyness, including deep in- and out-of-the-money options, where BSOPM biases differ. In this case, ATM contracts during turbulent conditions may have compounded sensitivities, driving theoretical values above depressed market quotes.

Second, foreign institutional investors (FIIs) pulled back sharply at year-end 2024: in December alone, FIIs offloaded US\$2.33 billion (₹19,848 crore) of Indian equities (EconomicTimes.com, 2025) despite a modest net monthly inflow overall, and over the quarter they withdrew a net US \$11.9 billion, sapping option-market liquidity and reducing demand on both sides of the book. The undervaluation of market prices observed in our analysis during the December–January window aligns with the institutional rebalancing dynamics documented by Harvey et al. (2025). Their study demonstrates that mandate-driven portfolio rebalancing—particularly at calendar endpoints like year-end—induces predictable equity sell-offs, depressing returns by approximately 17 basis points daily, with reversals occurring within two weeks. This transient selling pressure directly impacts option pricing. Third, global risk aversion—fanned by repeated threats of U.S. tariffs—drove Asian markets into a protracted risk-off stance, weakening both leverage-based call buying and speculative put hedging; Reuters notes that “amid global instability spurred by U.S. tariff policies,” investors sold US \$4 billion in Indian stocks in April 2025 alone.

An important factor contributing to the observed mispricing during the study period may be the significant decline in trading volumes following regulatory changes. In November 2024, the Securities and Exchange Board of India (SEBI) mandated that exchanges offer only one weekly expiry per index, leading the National Stock Exchange to discontinue multiple weekly option contracts, retaining only the Nifty 50 for weekly

expiries. This regulatory action resulted in a substantial decrease in derivatives trading activity, with average daily turnover for index options declining by over 37 percent in December 2024 compared to the previous month. Reduced trading volumes likely led to lower market liquidity, wider bid-ask spreads, and less efficient price discovery, thereby exacerbating deviations between theoretical and observed option prices.

Finally, during this same interval, the SEBI instituted regulatory changes—raising margins, altering contract specifications, and increasing transaction costs—to curb speculative derivatives trading. These measures further disincentivized participation in Futures and Options segments, narrowing bid-ask spreads and mechanically lowering observed premiums relative to the frictionless-market assumption of BSOPM. As a result, retail participation in Futures and Options fell by 18 percent month-on-month in December 2024, and daily index-options volumes plunged by 70 percent into early 2025, further draining liquidity and skewing market quotes.

In addition, an auxiliary comparison of the historical volatility inputs—computed over the thirty-day estimation window preceding the valuation period—revealed that Shariah-compliant stocks exhibited marginally lower annualized volatility and variance than non-Shariah stocks; however, this difference did not reach statistical significance and therefore did not materially influence the observed pattern of option undervaluation.

Overall, the predominance of market undervaluation in the research findings reflects the intersection of ATM strike focus, year-end and post-pandemic market troughs, regulatory tightening by SEBI, and geopolitical headwinds—factors that collectively suppressed option premiums below their Black–Scholes benchmarks. These findings highlight that mispricing is less a function of Shariah compliance and more a reflection of structural frictions in India’s derivatives market, while also illustrating that emerging market dynamics can diverge sharply from the overvaluation bias as reported in the developed markets.

6. Conclusion

This study highlights that option pricing inefficiencies in India during late 2024 and early 2025 cannot be fully explained by theoretical model limitations alone, but must be understood within the context of market microstructure, regulatory interventions, and institutional flows.

For market participants, these findings suggest that option mispricing is strongly event-driven and sensitive to regulatory cycles. Portfolio managers and traders should integrate such distortions into their derivative pricing and hedging strategies, especially around institutional rebalancing periods and policy shifts.

For Islamic finance, while conventional options remain impermissible, monitoring mispricing dynamics offers valuable insight into market volatility, enabling Shariah-compliant portfolio managers to design risk-mitigation tools aligned with Islamic principles. As Bacha (1999) argues, the outright rejection of derivatives overlooks their potential role in improving risk-sharing and liquidity when carefully structured to comply with Shariah. Thus, the insights from observed mispricing can inform the development of Shariah-compliant instruments that capture the risk-hedging benefits of derivatives without violating Shariah constraints.

For regulators, the results underscore the need to balance prudential measures with liquidity preservation. Abrupt specification changes, margin hikes, and cost increases can unintentionally impair price discovery and reduce market efficiency. By contrast, well-sequenced and transparent reforms can support both stability and efficient pricing.

This study remains limited to at-the-money 30-day single stock futures of NIFTY 50 constituents during a short interval coinciding with exceptional volatility. Broader samples across different maturities, strikes, and international comparisons would provide further clarity.

In summary, this paper contributes by documenting a systematic undervaluation bias in Indian options, offering empirical insights into how theoretical models interact with real-world frictions in both conventional and Shariah-relevant contexts, while also opening space for policy debate on the constructive use of derivatives in Islamic finance.

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The Relationship Between Financial Literacy and Financial Wellbeing Among Muslim Women in Indonesia and Malaysia

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Abstract

Women's participation in economic activity could contribute to the high annual global output. Good financial planning, as well as good financial knowledge, attitude, and behaviour, can improve women's wellbeing. The purpose of this study is to examine the relationship between financial literacy dimensions (knowledge, attitude, and behaviour) and financial wellbeing among women in Indonesia and Malaysia. A quantitative method of study is employed by distributing 411 questionnaires that consist of financial knowledge, financial attitude, financial behaviour, and financial wellbeing questions. Indonesian and Malaysian women were found to have a moderate level of financial knowledge. Financial knowledge was found to have a positive and significant relationship with financial attitude, but it has no significant relationship with financial behaviour. The financial attitude was found to have a positive and significant relationship with financial behaviour and mediates the relationship between financial knowledge and financial behaviour. Financial attitude and financial behaviour were found to have a positive and significant relationship with financial wellbeing. This study contributes to the literature by showing that financial knowledge alone does not directly lead to positive financial behaviour; instead, it shapes financial attitudes, which in turn influence behaviour. When women develop positive financial attitudes, they are more likely to practice responsible financial behaviours and make sound financial decisions. Thus, achieving financial wellbeing requires not only improving knowledge but also fostering the right financial attitudes that can translate knowledge into right financial behaviour.

Keywords: Women's financial literacy, financial wellbeing, financial knowledge, financial attitude, financial behaviour.

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1. Introduction

The development of women's empowerment is well recognized as an effective way to narrow the current gender gaps in the labor market as well as to promote inclusive growth. Women empowerment has been proven to have multiplier effects on decent employment, poverty eradication, and economic growth. The Economist (2006) made an assessment and argued that an increase in women's employment in the advanced world had been the main driving force of growth in the past couple of decades. Some of the official institutions, like the Organization for Economic Cooperation and Development (OECD), International Labour Organization (ILO), International Monetary Fund (IMF), World Bank, and United Nations (UN), as well as some private institutions and economists, have been working on piecing together substantial parts of the gender growth puzzle over decades. The goal is to quantify the increased impact the number of women in the paid workforce has had on past economic growth.

According to [OECD \(2012\)](#), the closing gender gap in the labor force will increase the Gross Domestic Product (GDP) by 12% over the next 15 years, and some emerging countries could see an increase of 20% or more in their GDP. Women's participation in economic activity could result in an additional US \$12 trillion to

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annual global output by 2025 (UN, 2018). Typically, women will spend more of their income to invest in their families (health, education, and welfare) than men do. In fact, women in the paid labor force can provide a double boost to human capital as well as the economy. In addition, according to a Global Entrepreneurship Monitor (GEM) *Women's Special Report (2015)*, men used 30 to 40 cents of every dollar they earned for their family's education, health, and nutrition, while women devoted 90 cents. Therefore, enhancing women's economic participation is critical for sustainable development goals, especially in achieving the specific goals of women's empowerment, zero poverty, gender equality, and quality education.

The *International Labour Organization (2018)* reported that the current global labor force participation rate for women is close to 49%. In comparison, men's participation is 75%. The figure shows a difference of 26% points. Along with the effort of closing the gender gap in labor participation, both men and women need to sufficiently understand financial literacy to participate in economic activities effectively and to make sound decision on financial decisions for themselves and their families. However, the need to improve financial literacy is even more pressing among women compared to men. Some studies showed that women tend to have a lower level of financial knowledge than men, suggesting that it may be difficult for them to face the challenges in achieving their financial wellbeing.

In today's modern era, the traditional view of women who should be at home has begun to shift. Good financial planning, as well as good financial knowledge, attitude, and behaviour, can improve women's welfare. What determines the gender gap in financial literacy still requires attention. Therefore, to improve financial literacy, it is necessary to survey what the important dimensions of financial literacy are to improve financial wellbeing.

Based on the previous study conducted by the author, Muslim women in Indonesia and Malaysia were found to have a moderate Islamic and general financial knowledge level (Diniyya et al, 2022). Several areas of weakness were found, including the understanding of the role of parties in the mudharabah contract, knowledge of zakat, and the simple time value of money calculation. Furthermore, this research is an extension of the previous study to address the gap in financial knowledge, attitude, behavior, and wellbeing among women in Indonesia in Malaysia, so that the result of this study will provide insights into the approach to improving women's financial literacy and financial wellbeing.

2. Financial literacy and financial wellbeing definition

Financial literacy is defined by the President's Advisory Council on Financial Literacy (PACFL, 2008) as the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial wellbeing. To accommodate the financial problem, women need financial literacy to manage their cash flow and money wisely to ensure the sustainability of their finances and support their families. Another definition of financial literacy for adults was stated by the OECD (Atkinson & Messy, 2012) as "a combination of awareness, knowledge, skill, attitude, and behaviour necessary to make a sound financial decision and achieve financial wellbeing." Financial literacy in the context of small and medium enterprises is defined as "the combination of awareness, knowledge, skill, attitude, and behaviour that an entrepreneur or an owner of the micro, small, medium businesses should have to for an effective financial decision making to start, run, and ensure the sustainability and growth of the business" (OECD, 2018). While Islamic literacy is defined as the ability of a person to use financial knowledge, skill, and attitude in managing financial resources according to the Islamic teachings (Rahim et al, 2016).

Financial wellbeing is defined as a state of mind that measures satisfaction with financial matters (Muleke & Murithi, 2013). *Consumer Financial Protection Bureau (2015)* defines financial wellbeing as a state of being wherein a person meets their current and ongoing financial obligations, feels secure in their financial future, and can make choices for a joyful life. An individual's financial wellbeing can be influenced by their financial decision, which are also affected by their financial literacy level. Addin et al. (2013) noted that individuals with higher financial literacy make better decisions and enjoy higher financial security and wellbeing.

3. Empirical Studies and Hypotheses Development

Studies reveal that financial literacy equips individuals with skills to navigate financial challenges, which fosters increased financial wellbeing (Lusardi & Messy, 2023; Estrada-Mejia et al., 2023). Mahendru et al. (2020) and Estrada-Mejia et al. (2023) found a direct positive correlation between financial literacy and financial wellbeing. They suggested that individuals with greater financial knowledge are better positioned to meet their financial obligations and feel secure in their financial future. Individuals who have strong financial

knowledge tend to have a greater financial attitude. [Atmaningrum et al. \(2021\)](#) argued that better financial knowledge can support the development of positive financial attitudes because people can understand when they can apply their financial knowledge and can relate their knowledge of their knowledge to their financial behaviours. The empirical evidence suggests that financial knowledge creates a sense of responsibility and a proactive role in planning their finances. According to [Selvia et al. \(2021\)](#), financially knowledgeable individuals are likely to demonstrate better financial behaviours such as planning and managing, which influences their attitudes positively toward their finances.

Above all, people can make informed decisions when they understand that their financial decisions will have certain consequences and thus develop discipline to budget and save and positively influence their overall financial attitude ([Atmaningrum et al., 2021](#)). Additionally, financial attitudes may also reflect an individual's financial knowledge. [Loppies \(2023\)](#) notes that individuals who have a good grasp of financial concepts develop more disciplined financial habits and practice budgeting and savings. From the relationship between financial knowledge and financial attitude found in previous studies, the following hypotheses are developed:

H1: Financial Knowledge has a significant relationship with financial attitude.

[Selvia et al. \(2021\)](#) argued that financial knowledge allows individuals to make effective financial decisions and handle their resources, thereby leading to improved financial behaviour and financial planning. [Lukesi et al. \(2021\)](#) supported this argument and found that increased financial knowledge has a clear role relating to effective financial management behaviour among the millennial generation. This is consistent with the idea that those who understand financial concepts will demonstrate responsible actions towards their finances ([Lukesi et al., 2021](#)).

Financial behaviour is frequently indicated by how a person utilises their financial knowledge in real-life situations. [Masdupi et al. \(2020\)](#) argued that there is a strong positive correlation between financial knowledge and financial behaviour in a productive-age community and illustrated that individuals with a better understanding of the financial context tend to act in a much more proactive financial behaviour, such as budgeting and managing expenses. These behaviours are crucial for personal financial management and long-term financial wellbeing. Therefore, the following hypotheses are developed:

H2: Financial Knowledge has a significant relationship with financial behaviour.

An individual's financial attitudes, which refer to personal beliefs and feelings toward managing finances, significantly influence their financial behaviour. A positive financial attitude cultivates financially responsible behaviours. While a negative financial attitude may result in poor financial behaviours ([Loppies, 2023; Anisah et al., 2023](#)).

Research shows that individuals with positive financial attitudes are more likely to participate in positive financial practices, including budgeting, saving, and investing as opposed to impulsive spending and accumulating debt. For example, [Tuffour et al. \(2020\)](#) concluded that financial attitudes have a direct effect on how individuals manage their personal financial resources, emphasising that thinking of finances positively enhances financial performance. This idea is further supported by [Loppies \(2023\)](#), who argued that there is a statistically significant relationship between financial attitude and financial behaviour. Moreover, positive financial attitudes are associated with better self-control in spending. According to [Anisah et al. \(2023\)](#), a sound financial attitude reflects an individual's ability to budget and execute financial plans, which are important components of positive financial behaviour. This indicates that when individuals have a positive attitude towards financial management, they are more likely to translate that attitude into responsible financial behaviour. From the findings above, the following hypotheses are developed:

H3a: Financial attitude has a significant relationship with financial behaviour.

Furthermore, [Yeolencia and Lestari \(2024\)](#) suggest that financial attitude can mediate the relationship between financial knowledge and financial behaviour. Their study indicates that individuals with positive financial attitudes are more likely to implement the financial knowledge they have acquired into actionable financial behaviours. Additionally, [Çoşkun & Dalziel \(2020\)](#) pointed out that financial attitudes help bridge the gap between what individuals know about finance and how they behave in financial contexts. In their survey, they found that when financial attitude acts as a mediator, the relationship between financial knowledge and financial behaviour becomes stronger, according to the SEM analysis. Thus, we develop the following hypothesis:

H3b: Financial attitude mediates the relationship between financial knowledge and behaviour.

Several studies have shown a positive correlation between good financial behaviours and better financial wellbeing. Kumar et al (2023) showed that different kinds of financial behaviours, such as managing credit responsibly and savings, are amongst the strongest determinants of financial wellbeing. Arsalan et al (2022) support this notion, and they identified that better financial behaviours will lead to a greater acceptance of financial inclusion and access to products that will produce enhanced security, and ultimately greater overall financial wellbeing. Botha et al (2024) observed that good financial behaviours are essential as a strategy for financial wellbeing. They highlighted the importance of continued financial literacy as part of developing habitual behaviours such as saving and wise spending for achieving higher overall financial wellbeing. Additionally, Sehrawat et al. (2021) found a significant positive link between responsible financial behaviours and perceived financial wellbeing. They suggest that individuals who practice sound financial management perceive themselves as having a better financial situation and future (Sehrawat et al., 2021). Based on this literature, the following hypothesis is developed:

H4: Financial behaviour has a significant relationship with financial wellbeing.

In addition, Nuraini et al. (2019) stated in their study that attitude toward money has a positive relationship with financial wellbeing. This finding is also supported by a study by Setiyani and Solichatun (2019) on financial wellbeing among university students, which found that financial attitude has a positive relationship with financial wellbeing. They stated that financial attitude could make the students more concerned about their financial prosperity. A study by Owusu (2021) suggests that individuals with a positive financial attitude are more likely to experience higher levels of financial satisfaction, which positively influences overall financial wellbeing. Therefore, the following hypothesis is developed:

H5: Financial attitude has a significant relationship with financial wellbeing.

4. Review of conceptual and theoretical perspectives: knowledge-attitude-behaviour model

The knowledge, attitude, and behaviour (KAB) model, or in another study known as the Knowledge, Attitude, and Practice (KAP) model, is widely used in health education fields. This model is commonly used in a survey to study a specific population and collect information on what is known, believed, and done on a particular topic (WHO, 2008). The survey on knowledge, attitude, and behaviour can be used to describe the current population's knowledge, attitude, practice or behaviour, problem identification, and intervention planning. In a study by Bano et al. (2013), this model suggests that an increase in knowledge affects attitude and consequently changes the practice.

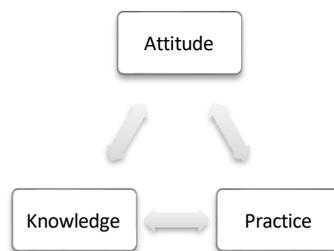


Figure 1. Knowledge- Attitude- Practice model. Source: Bano et al. (2013)

According to Scharader & Lawless (2004), Ajzen and Fishbein (1977) reported that although attitude is not the sole indicator of behaviour, it is one of the factors in determining behaviour. What an individual knows about a particular topic will inform his/her attitude about that topic, and then what he/she knows about that topic may influence his/her behaviour. Previously, Fishbein (1967) indicated that attitude could also be aligned with behaviour, and behaviour can inform attitudes; then attitude will influence the intention. Thus, attitude can impact individuals' perceptions and, therefore, impact the knowledge of that individual. Therefore, Scharader & Lawless (2004) concluded that the relationship between these three dimensions of knowledge, attitude, and behaviour is dynamic and sometimes reciprocal.

Financial knowledge is an important component of financial literacy that helps individuals compare financial products and services and make sound financial decisions. Sanderson (2015) defined financial literacy

as an individual's capability to use his/ her knowledge and skills to make an appropriate financial decision for effective financial management. In addition, [Huston \(2010\)](#) defined financial knowledge as an understanding of key financial terms and concepts for financial decisions.

Financial attitude is defined as a state of mind, opinion, and judgment about finances ([Pankow, 2012](#)). Some studies found that financial attitude is influenced by financial knowledge ([Yahaya et al., 2019](#); [Hussain et al., 2018](#); [Coskun & Dalziel, 2020](#)). Furthermore, financial behaviour is an essential element of financial literacy, and it is found to be a determinant of financial literacy ([OECD, 2013](#)). Financial knowledge and financial attitude were found to have a positive relationship with financial behaviour ([Lukesi et al., 2021](#); [Masdupi et al., 2020](#); [Anisah et al., 2023](#); [Loppies, 2023](#); [Potrich et al., 2016](#); [Serido et al., 2013](#); [Yahaya, 2019](#)). Basically, the KAB model states that as knowledge increases, attitude will change, and later, it leads a person to eventually change their behaviour towards a particular outcome.

5. Conceptual Framework

Based on the literature, financial literacy significantly affects financial wellbeing. In this conceptual framework, we draw down the dimensions of financial literacy into three aspects: financial knowledge, financial attitude, and financial behaviour. The dependent variable of this research is financial wellbeing, which is the variable of primary interest. This chapter attempts to explain the variance in this dependent variable by four independent variables (1) financial knowledge, (2) financial attitude, and (3) financial behaviour. Based on the literature review, it was found that financial knowledge influences financial attitude, which later influences financial behaviour. Therefore, financial attitude will be observed as the mediating variable in the relationship between financial knowledge and financial behaviour.

The proposed conceptual model consists of two dimensions, namely the knowledge and application dimensions. Perceiving financial literacy is a process that starts with input, throughput, and output. According to [Huston \(2010\)](#), the first path of financial literacy occurs from the change in attitude due to the improvement of financial knowledge. The second path is where financial knowledge has a direct impact on financial attitude and behaviour which resulting in financial wellbeing. The proposed research framework is shown in Figure 2.

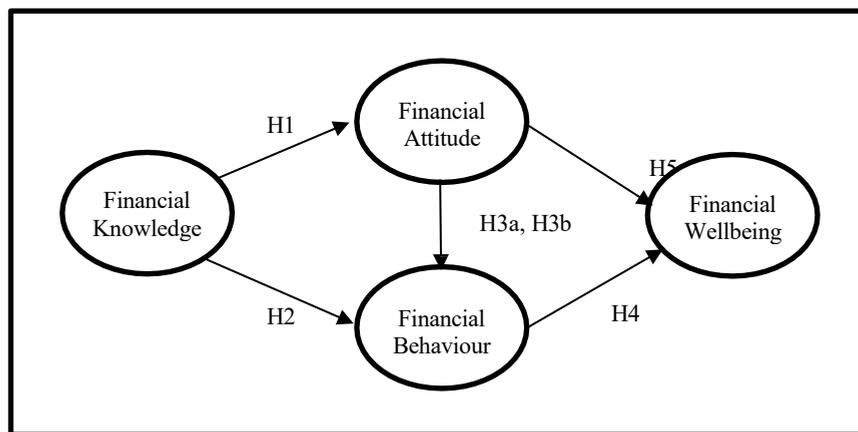


Figure 2: Research Framework

6. Methodology

This study employs a purposive sampling method, targeting educated Muslim women in urban areas of Indonesia and Malaysia, as they are more likely to engage with both conventional and Islamic financial products. The questionnaires were distributed to 206 Indonesian women and 205 Malaysian women, with a total of 411 respondents. The sample size of each country is considered adequate to ensure sufficient statistical power and representativeness ([Sathyanarayana et al., 2024](#)). The data collection was completed in 2022, with the questionnaire consisting of two types. The first is the questionnaire of financial knowledge, which uses true or false questions about basic knowledge of Islamic and general financial literacy. Second, the questionnaire is divided into three categories based on the variables of the study, namely, financial attitude, financial behaviour, and Islamic financial wellbeing. The closed question in the questionnaire will employ a five-point Likert scale to measure the tendency of the respondent on each variable.

7. Findings and Discussion

The total data collected for this study is 411. 50.1% (n = 206) are Indonesian respondents, and 49.9% (n = 205) are Malaysian respondents. 64.5% of the respondents are 23-29 years old. The majority of women in this study are single at 54.5%, followed by married women at 42.3%. In terms of education, 56.0% of the respondents hold a bachelor's degree, while 34.8% hold a Master's degree. Women with private employee occupations are dominant, with a 30.2% contribution.

Table 1: Demographic profile of respondents

Indonesian Respondents		Malaysian Respondents		Total percentage
Age	Total	Age	Total	
18-21	1	18-22	27	6.8%
23-29	135	23- 29	130	64.5%
30-45	65	30-45	42	26.0%
46 Above	5	46 Above	6	2.7%
Marital Status		Marital Status		
Single	81	Single	143	54.5%
Married	119	Married	55	42.3%
Widowed	6	Widowed	4	2.4%
Divorced		Divorced	3	0.7%
Education		Education		
Senior High School	0	Senior High School	7	1.7%
Junior High School	0	Junior High School	3	0.7%
Diploma	9	Diploma	12	5.1%
Bachelor	118	Bachelor	112	56.0%
Master	74	Master	69	34.8%
PhD	5	PhD	2	1.7%
Occupation		Occupation		
Undergraduate Student	3	Undergraduate Student	60	15.3%
Postgraduate Student	30	Postgraduate Student	42	17.5%
Self-employed (Entrepreneur)	20	Self-employed (Entrepreneur)	8	6.8%
Civil Servant / government employee	22	Civil Servant / government employee	30	12.7%
Private employee	69	Private employee	55	30.2%
Housewife	40	Housewife	8	11.7%
Other	22	Other	2	5.8%
Monthly Income		Monthly Income		
Rp1.000.000-3.000.000	73	Less than RM 1000	90	39.7%
Rp3.000.000-5.000.000	67	RM 1,000- RM 3,000	63	31.6%
Rp5.000.000-10.000.000	36	RM 3,000- RM 5,000	41	18.7%
Rp 10.000.000-20.000.000	26	RM 5,000 & above	11	9.0%
Rp 20.000.000 & above	4			1.0%
Total	206	Total	205	100.0%

8. Data Analysis

The data obtained from the respondents through the questionnaire were analyzed using a quantitative technique. The quantitative analysis used to test the hypotheses of this study is the Structural Equation Model (SEM)

analysis using AMOS version 24. The Structural Equation Model is used to examine the relationship among the constructs. According to Hair et al. (2006), SEM is the best analytical method to test multiple effects between independent and dependent variables simultaneously. Furthermore, to test the mediation analysis of the hypothesis, the Sobel Test was taken to test the significance of a mediation effect.

Table 2: Questionnaire statements

Construct	No	Items/ statements
Financial Knowledge	1	Islamic method of finance is interest-free (True)
	2	Gharar refers to any transaction in which its existence or description of the object is not certain due to a lack of information and knowledge on the ultimate result of the contract (True)
	3	An Islamic financial institution may invest with you according to the profit-sharing method (Mudarabah) (True)
	4	In Mudarabah, the capital provider is the only party that born the losses (True)
	5	Zakat is a determined amount of wealth that is paid annually from a person's wealth according to the methods and rulings of Islam to those who have the right to receive it. How much is the amount of <i>nisab</i> for Zakat Mal? (85 gram of gold)
	6	Takaful can provide coverage and benefits similar to conventional insurance (True)
	7	Suppose you put \$100 into a (no fee, tax-free) savings account with a profit rate of 2.78% per year. You don't make any further payments into this account, and you don't withdraw any money. Once the profit is paid, your money in the account at the end of the first year would be \$102.8 (true)
	8	Buying shares on a short-term price fluctuation is not speculation (False)
	9	An investment with a high return is likely to be high risk/ or If someone offers you the chance to make a lot of money, it is likely that there is also a chance that you will lose a lot of money (True)
	10	Inflation doesn't affect the living cost (False)
Financial Behaviour	1	I tend to worry about paying my normal living expenses.
	2	My finances control my life.
	3	Before I buy something, I carefully consider whether I can afford it
	4	I have money left over at the end of the month, and I am willing to save it
	5	I pay my bills on time
	6	I am happy to discuss my financial situation with people I know well
	7	I set long term financial goals and strive to achieve them
	8	I keep a close personal watch on my financial affairs
	9	If I borrow money, I have a responsibility to pay it back
	10	Even on a low income, I save a little regularly
	11	I contribute to an investment account.
Financial Attitude	1	I am concerned that my money won't last
	2	My financial situation limits my ability to do the things that are important to me
	3	When I have savings, I will not spend them soon to realize my wishes
	4	I have the feeling that money and finances are not too complicated for me
	5	When I have money, I should not flaunt it
	6	If today I will withhold some expenses and save, I will be better off in the future
	7	I rarely spend more money than I intended too
	8	I rarely buy things without thinking whether I can afford them or not
	9	I think I am capable of managing my money
	10	I am not troubled by financial worries
	11	Having debt is never a good thing
	12	I know how to determine how much money need to live comfortably throughout retirement

	13	I feel putting away money each month for savings or investments is important
Financial Wellbeing	1	I could handle a major unexpected expense
	2	I am securing my financial future
	3	Because of my money situation, I feel like I will never have the things I want in life
	4	I can enjoy life because of the way I'm managing my money
	5	I am just getting by financially
	6	I am concerned that the money I have would not last
	7	Giving a gift for a wedding, birthday, or other occasions would put a strain on my finances for the month
	8	I have money left over at the end of the month
	9	I am behind with my finances
	10	My finances control my life

8.1. Goodness-of-Fit Test

The measurement model test is to test the relationship between indicators and latent variables. The combination of structural model testing and measurement allows researchers to test measurement error as an integral part of SEM and perform factor analysis along with hypothesis testing (Bollen, 1989). According to Ghazali (2004), two steps must be taken. First is a path diagram, which arranges the structural model by relating the latent constructs, including endogenous and exogenous. The second is the structural equation, which is arranged in the measurement model. Path diagrams and structural equations show the causal relationship between financial knowledge, financial attitude, and financial behaviour towards financial behaviour. The path diagram and structural equation using AMOS software are shown in Figure 3.

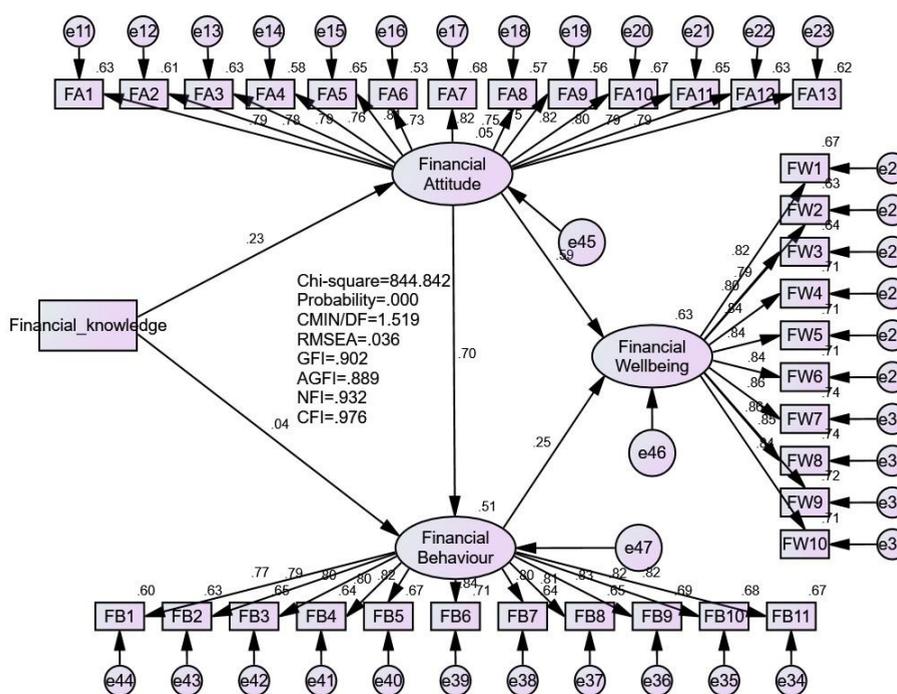


Figure 3: Path diagram and Structural Equation Model (AMOS)

The goodness-of-fit test is used to determine whether the model can be statistically accepted or not. Nevertheless, the goodness-of-fit test is not used to evaluate whether the paths in the model are statistically significant or not. If the model is statistically accepted, the paths in the model can be interpreted. Fit index and cut off the value that is used to test whether the model can be accepted or not are as follows Chi-Square, Root

Mean Square Error of Approximation (RMSEA), Normed Fit Index (NFI), Comparative Fit Index (CFI), Normed Fit Index (NFI), Goodness of Fit Index (GFI), and Adjusted Goodness of Fit Index (AGFI).

Table 3: Goodness of Fit Index

Fit Measure	Good Fit	Acceptable	Result	Criteria
χ^2	$0 \leq \chi^2 \leq 2df$	$2df < \chi^2 \leq 3df$	844.842	Good Fit
p value	$.05 < p \leq 1.00$	$.01 \leq p \leq .05$	.000	Acceptable
χ^2 / df (CMIN/DF)	$0 \leq \chi^2 / df \leq 2$	$2 < \chi^2 / df \leq 3$	1.519	Good Fit
RMSEA	$0 \leq RMSEA \leq .05$	$.05 < RMSEA \leq .08$	.036	Good Fit
NFI	$.95 \leq NFI \leq 1.00$	$.90 \leq NFI < .95$	.932	Acceptable
CFI	$.97 \leq CFI \leq 1.00$	$.95 \leq CFI < .97$	.976	Good Fit
GFI	$.95 \leq GFI \leq 1.00$	$.90 \leq GFI < .95$	.902	Acceptable
AGFI	$.90 \leq AGFI \leq 1.00$, close to GFI	$.85 \leq AGFI < .90$, close to GFI	.889	Acceptable

The Absolute Fit Measures measured by Likelihood Chi-square, probability, CMIN/DF, GFI, and RMSEA, have all reached the cut-off value. The Incremental Fit Measured, which is measured by AGFI, CFI, and NFI, has all reached the cut-off value. Overall, Table 3 shows that Likelihood Chi-square, probability, CMIN/DF, GFI, RMSEA, AGFI, CFI, and NFI have reached the cut-off value. It can be concluded that the parameter has met the expected requirement, and the model meets the assumption of the Goodness of Fit model.

8.2. Validity and Reliability of Measurement Model

Indicators are said to be valid if they have a loading factor value with the latent variable to be measured more or equal to 0.5 (≥ 0.5); if one of the indicators has a loading value less than 0.5, then the indicator must be dropped because it will indicate that the indicator is not good enough to measure the variable latent appropriately. The Confirmatory Factor Analysis is established to find the loading factor of each indicator. The results of the CFA validity test show that the value of the loading factor on all variable items is more than 0.5; thus, the indicators are considered valid.

The alpha scale is used to test the reliability of the data. Reliabilities less than 0.600 are considered poor, while those in the 0.700 range are considered acceptable, and those in the range over 0.800 are considered good (Sekaran & Bougie, 2013). If Cronbach's alpha is more than 0.600, it can be considered acceptable and good for other measures. The result of the reliability test of this study shows that all variables are reliable.

Table 4: Loading Factors and Cronbach's Alpha

Items	Loading factor	Reliability
Financial knowledge	-	0.611
FA1	.794	0.952
FA2	.780	
FA3	.792	
FA4	.763	
FA5	.809	
FA6	.729	
FA7	.822	
FA8	.753	
FA9	.749	
FA10	.818	
FA11	.804	
FA12	.792	
FA13	.788	
FW1	.817	0.958

FW2	.795	
FW3	.802	
FW4	.844	
FW5	.840	
FW6	.842	
FW7	.858	
FW8	.861	
FW9	.846	
FW10	.842	
FB11	.817		0.954
FB10	.822	
FB9	.832	
FB8	.806	
FB7	.798	
FB6	.844	
FB5	.817	
FB4	.802	
FB3	.803	
FB2	.792	
FB1	.773	

8.3. Normality Test and Outlier Evaluation

Data assessment for normality is an essential step in almost all multivariate analyses. In applying the method of maximum likelihood estimation, the normal distribution of each variable is required (Kline, 2010). One way to examine the normality assumption is by looking into the skewness and kurtosis values of univariate variables. McDonald and Ho (2002) suggested that the normality assumption is achieved if skewness and kurtosis values are no more than 3.0 and 10.0, respectively. The result shows that a normal assumption is achieved since all skewness values are less than 3.0 and the kurtosis value is less than 10.0.

Outlier evaluation is carried out to see the condition of observations from data that have unique characteristics that look very different from other observations and appear in extreme forms, either for a single variable or for combination variables (Hair et al., 2010). Evaluation of the Multivariate Outliers can be observed from the value of Mahalanobis Distance. Suppose the Mahalanobis d-Squared on AMOS computation is greater than the Chi-Square value in the degree of freedom of the number of item variables, and at the level of significance is 0.001. In that case, the data indicates the existence of Multivariate Outliers (Waluyo, 2016). The CHIINV function in Excel was calculated to find the critical value of the Outlier test. Based on the calculation in Microsoft Excel, the critical value for the outlier test is 67.985. The obtained highest value on Mahalanobis d-Squared is 65.984. There were no outliers found in the Mahalanobis distance since the Mahalanobis d-Squared value is less than 67.985.

8.4. Structural Equation Model (SEM) Evaluation on Hypotheses Testing.

The objective of this study is to find the relationship between financial knowledge, financial attitude, and financial behaviour. For this purpose, six hypotheses have been developed based on the literature and the theory of knowledge, attitude, and behaviour model (KAB model). Based on the result, five of these hypotheses are found to be statistically significant, and only one of the hypotheses is rejected. Table 5 shows the statistical result based on the maximum likelihood estimation and the parameter estimates that support the adequacy-modified model.

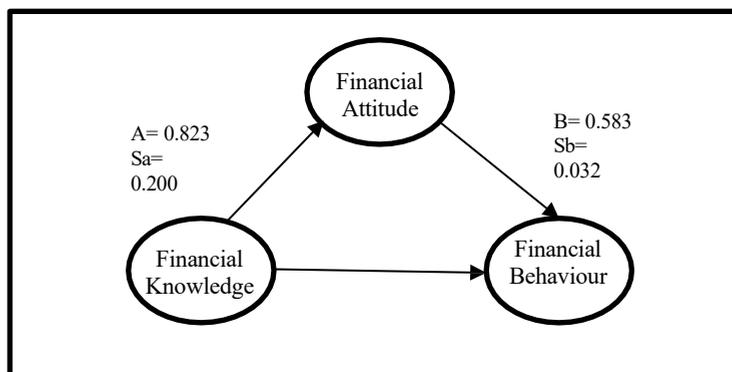
Table 5: Statistical Result

H	Hypothesized Path	Estimates	S.E.	Remark	Decision
H1	FK → FA	.080	.018	***	Financial Knowledge and Financial Attitude are significant and positively related (Supported)
H2	FK → FB	.017	.014	.252	Financial Knowledge and Financial Behaviour are not significant and not positively related (Not supported)
H3a	FA → FB	.766	.056	***	Financial Attitude and Financial Behaviour are significant and positively related (Supported)
H3b	FK → FA → FB	The Sobel Test result shows a value of 4.01, which is higher than 1.96 (critical value for the Sobel Test) and a significant value of 0.000 (<0.05).			According to the Sobel Test, there is an indirect effect of Financial Knowledge on Financial Behaviour through Financial Attitude (Supported)
H4	FB → FW	.240	.049	***	Financial Behaviour and Financial wellbeing are significant and positively related (Supported)
H5	FA → FW	.617	.060	***	Financial Attitude and Financial wellbeing are significant and positively related (Supported)

8.5. Sobel Test for Mediating Effect Evaluation

Mediation testing was done by using the Sobel Test. The results of the Sobel Test can be shown in Figure 4. Before conducting the Sobel Test, the path analysis through regression using SPSS 26.0 was conducted to find the regression coefficients. Afterwards, the regression coefficient value was used to calculate the result of the Sobel Test. According to Preacher K & Hayes (2004), the rough critical value for the two-tailed version of the Sobel Test, assuming that the sampling distribution is normal, is 1.96.

Figure 4: Path analysis of the mediation effect



The Sobel Test result shows a value of 4.01, which is higher than 1.96 (critical value for the Sobel Test) and a significant value of 0.000 <0.05; thus, there is an indirect effect of Financial Knowledge on Financial Behaviour through Financial Attitude. The result implies that Financial Attitude mediates the relationship between Financial Knowledge and Financial Behaviour.

Input:		Test statistic:		Std. Error:	p-value:
a	0.823	Sobel test:	4.01388818	0.11953721	0.00005973
b	0.583	Aroian test:	4.00814759	0.11970842	0.0000612
s _a	0.200	Goodman test:	4.01965351	0.11936576	0.00005828
s _b	0.032	Reset all	Calculate		

Figure 5: The Sobel Test result

The statistical analysis of this study found that among six hypotheses, only five of them are supported, and one is not supported. Financial knowledge was found to have a positive and significant relationship with financial attitude, but it has no significant relationship with financial behaviour. Financial attitude was found to have a positive and significant relationship with financial behaviour. The result shows that financial attitude mediates the relationship between financial knowledge and financial behaviour when testing the mediation effect of financial attitude on financial knowledge and financial behaviour. Lastly, financial attitude and financial wellbeing were found to have a positive and significant relationship with financial wellbeing.

9. Discussion of Results

The Structural Equation Model (SEM) was used to analyse the relationship between the dimensions. To achieve this objective, four hypotheses were developed to examine the relationship between the variables (H1, H2, H3a, and H3b).

The statistical result shows that in hypothesis H1, financial knowledge was found to have a positive and significant relationship with financial attitude. If financial knowledge among women is increased, their financial attitude will also be improved. This finding supports the previous studies (Yahaya et al., 2019; Salia & Karim, 2018; Coskun & Dalziel, 2020; Selvia et al., 2021; Loppies, 2023), which found that financial knowledge positively affects financial attitude.

In the second hypothesis (H2), financial knowledge was found to have a positive relationship with financial behaviour. Meaning that if financial knowledge is increased, financial behaviour will also increase. However, the statistical result shows a low confidence level of 74.8 % (or a significant level of 0.252 (>0.05)). Even though some previous studies support that financial knowledge has a positive relationship with financial behaviour, this hypothesis is not supported by this study due to the low confidence level. This result failed to support the previous findings on the significant relationship between financial knowledge and financial behaviour (Selvia et al., 2021; Lukesi et al., 2021; Masdupi et al., 2020).

The relationship between financial attitude and financial behaviour was examined in the third hypothesis (H3a). The increase in financial attitude will be followed by an increase in financial behaviour. When women have a positive financial attitude, they will likely have positive financial behaviour as well. Although financial knowledge was found not to have a significant relationship, the financial attitude was found to mediate this relationship. Hypothesis H3b found that financial knowledge has an indirect relationship with financial behaviour through financial attitude. This result supports the previous studies by Serido et al. (2013), Coskun and Dalziel (2020), and Yeolencia and Lestari (2024).

Financial wellbeing is the dependent variable of this study. Two financial literacy dimensions, namely financial attitude and behaviours were examined to find a relationship with financial wellbeing. The study found that financial attitude and financial behaviour (H4 & H5) positively influenced financial wellbeing at a significant level. It indicates that any increase in financial attitude and financial behaviour will affect women's financial wellbeing.

An important practical implication provided by the result of this study arises from the rejection of H2, which stated that financial knowledge does not significantly influence financial behaviour. This indicates that simply assisting women to increase their financial knowledge is not enough to change their financial behaviour. Financial attitudes are found to be an important mediating factor in translating financial knowledge into financial behaviours. For policymakers, this study suggests that initiatives to improve women's financial literacy should not only focus on women's technical knowledge but also address the attitudes, perceptions, and values relating to money management. Integrating modules that build confidence, financial self-efficacy, and alignment with Islamic financial principles, such as responsible spending, zakat obligation, and avoidance of

riba, may help women internalize knowledge and transform it into positive financial behaviours. Such a holistic approach would enable policymakers to design more effective financial literacy and empowerment programs, thereby supporting the achievement of financial wellbeing as a key component of the Sustainable Development Goals (SDGs).

10. Conclusion

What determines the gender gap in financial literacy still requires attention. This study evaluates the dimensions of financial literacy, namely financial knowledge, financial attitude, and financial behaviour among women in Indonesia and Malaysia. Financial knowledge was found to have a direct and positive relationship with financial attitude, but not a direct relationship with financial behaviour. However, financial attitude was found to mediate the relationship between financial knowledge and financial behaviour. It implies that in order to have positive financial behaviour, women must have a positive attitude, which is influenced by their level of financial knowledge. Lastly, the two financial literacy dimensions, namely financial attitude and financial behaviour, were found to have a positive and significant relationship with financial wellbeing. To achieve positive financial wellbeing, someone must have a positive financial attitude and financial behaviour as well. A positive mindset and perception of finance, followed by good and positive financial practice, will help Muslim women achieve their financial wellbeing and make sound financial decisions.

Besides the significant efforts made to achieve the research objectives, there have been inevitable limitations due to time constraints. The sample size of 411 respondents with a proportion of 50:50 for each country is enough for the validity and reliability of the data, and a generalisation result may require the involvement of more respondents. In addition, data from the two countries are then combined to find a relationship between the dimensions of financial literacy and financial wellbeing. However, different results might occur if the data from the two countries were analysed separately. This can be a suggestion for further research to analyse the relationship between the dimensions of financial literacy and financial wellbeing in a specific country.

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Maqasid al-Shariah-Based Strategies for Enhancing Digital Adoption Among B40 Muslim Entrepreneurs

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Abstract

In Malaysia's pursuit of a digital economy, many B40 Muslim entrepreneurs remain excluded due to socioeconomic constraints and a lack of alignment between digital initiatives and Islamic ethical values. This study investigates how *Maqasid al-Shariah* principles can be strategically applied to enhance digital adoption among this underserved group. The objective is to develop a values-driven framework that integrates Islamic ethical priorities into digital inclusion strategies. A qualitative methodology was employed, combining library research for conceptual and theoretical grounding with focus group discussions (FGDs) involving Islamic scholars, digital economy practitioners, policymakers, and B40 Muslim entrepreneurs to capture diverse perspectives and enhance validity. The findings reveal that the fundamental objectives of *Maqasid al-Shariah*, especially protection of wealth (*Hifz al-Mal*) and dignity (*Hifz al-'Ird*), provide a relevant foundation for fostering ethical and sustainable digital adoption. Sub-themes include incentivizing compliance, integrating Islamic values into digital tools, promoting Shariah-compliant financial products, and leveraging religious institutions for digital education. This study offers practical and theoretical contributions by proposing a *Maqasid al-Shariah*-based digital inclusion framework for Muslim entrepreneurs in the B40 segment. Its implications extend to policymakers, Islamic fintech developers, and educators seeking to promote equitable and ethically grounded digital participation in Muslim-majority societies.

Keywords: Maqasid Shariah, Digital Adoption Strategies, B40 Muslim Entrepreneurs, Strategies

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1. Introduction

In an era of rapid technological advancement, digital innovation has become a central driver of economic participation, particularly within entrepreneurial sectors. In Malaysia, efforts to foster a robust digital economy are steadily progressing, with digital contributions to national GDP projected to reach 25.5% by 2025 (DOSM, 2024). Despite this momentum, a significant segment of the population, namely the Bottom 40 percent (B40) income group, remains marginalized from the benefits of digital transformation. Among these are Muslim entrepreneurs who face dual challenges: limited access to digital tools and the need to align technological engagement with Islamic ethical and legal principles (Subramaniam et al., 2024). This complex intersection of economic disadvantage and religious obligation necessitates targeted, values-based strategies to foster inclusive digital participation (Bin Sitisir et al., 2023).

The concept of *Maqāsid al-Sharī'ah*, or the higher objectives of Islamic law, seeks to preserve five essential values: religion (*al-dīn*), life (*al-nafs*), intellect (*al-'aql*), progeny (*al-nasl*), and wealth (*al-māl*). While widely applied in the fields of Islamic finance, governance, and healthcare (Ali et al., 2021; Hanif, 2019),

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its potential to inform digital inclusion strategies, particularly among marginalized Muslim entrepreneurs, has not been fully explored. Recent research indicates promising avenues for the application of *Maqāṣid* principles in digital financial services. For instance, [Ab. Aziz et al. \(2023\)](#) proposed a *Maqāṣid*-based Islamic digital banking model in Malaysia that emphasizes ethical inclusivity and spiritual trust. These studies underscore the utility of *Maqāṣid al-Sharī'ah* in structuring ethical digital systems that promote socioeconomic equity. Nevertheless, B40 Muslim entrepreneurs in Malaysia continue to face numerous barriers to digital engagement. Economically, many lack access to microfinancing, digital marketplaces, and formal business registration ([Tumiran & Mohammad, 2024](#)). Culturally, concerns about the halal status of online services, data privacy, and ethical behavior in digital spaces contribute to a general hesitancy toward digital platforms. Technologically, low digital literacy, insufficient training programs, and limited infrastructure further constrain their participation ([Komaruddin et al., 2023](#); [Zulkifli & Yusuf, 2023](#)). These interrelated barriers call for a multidimensional approach that integrates technological solutions with ethical, religious, and socio-economic considerations.

This study explores strategies to boost digital adoption among B40 Muslim entrepreneurs in Malaysia, guided by *Maqāṣid al-Sharī'ah*. It hypothesizes that Islamic value-based digital strategies will gain greater trust and acceptance. Using a library method, the first phase analyzes classical and modern *Maqāṣid* literature, while the second gathers qualitative data through focus group discussions with scholars, policymakers, digital experts, and B40 entrepreneurs. Thematic analysis will identify key barriers and values-driven solutions. The remainder of this paper is divided into four sections. The first section presents a literature review of the key terms used in the study. The second section outlines the research methodology. The third section explains the research findings, while the fourth section provides a discussion of the findings, followed by the study's implications and conclusion.

2. Literature Review

2.1 *Maqasid al-Shariah*

Maqasid al-Shariah, or the higher objectives of Islamic law, represents the ethical and spiritual aims underpinning Islamic jurisprudence. Al-Shatibi ([Al-Shāṭibī, 2019](#)) outlined five fundamental objectives (*daruriyyat*): the preservation of religion (*Hifz al-Din*), life (*Hifz al-Nafs*), intellect (*Hifz al-'Aql*), lineage (*Hifz al-Nasl*), and wealth (*Hifz al-Mal*). These objectives serve as a moral compass in formulating laws and policies that promote human welfare and justice. [Auda \(2007\)](#) posits an expanded scope of *Maqasid* to include broader concerns such as human dignity, social justice, and public interest (*maslahah*), positioning it as a dynamic and adaptable framework for modern challenges. In economic and technological contexts, *Maqasid* has been applied to Islamic finance, governance, education, and now increasingly to digital transformation. It enables the integration of *Shariah* principles into policy and innovation, ensuring ethical alignment with Islamic worldviews. For marginalized communities like B40 Muslim entrepreneurs, a *Maqasid*-based approach provides a holistic method for empowering individuals while maintaining spiritual integrity ([Güney, 2024](#)). Thus, applying *Maqasid* in digital inclusion efforts ensures that the use of technology not only advances efficiency and access but also protects fundamental human and moral values in line with Islamic teachings.

2.2 *Digital Adoption*

Digital adoption is more than just using technology; it involves understanding, integrating, and applying digital tools in meaningful ways that improve one's daily life or business operations. In countries like Malaysia, the government has invested heavily in digital infrastructure and inclusion programs, yet many groups, especially low-income communities, are still left behind ([Malaysia Strategic Change Management Office, 2021](#)). Issues such as affordability, lack of digital literacy, and unfamiliarity with online systems continue to hinder progress. For entrepreneurs, going digital can open new markets, improve productivity, and increase competitiveness. However, adoption rates remain uneven, particularly among vulnerable groups like the B40. Research shows that people are more likely to embrace digital tools when these tools align with their values, lifestyle, and trust levels ([Kreiterling, 2023](#); [Sudewa et al., 2023](#)). In Muslim communities, ethical and religious concerns often influence how people engage with technology. For instance, trust in fintech platforms or digital marketplaces can depend on whether they reflect Islamic values like transparency, fairness, and responsibility. Therefore, improving digital adoption among underserved groups requires more than just access; it must include trust-building, value-based education, and tools designed with cultural and ethical sensitivities in mind.

2.3 B40 Entrepreneurs

B40 entrepreneurs in Malaysia represent a vital but often overlooked segment of the economy. These are individuals from the lowest 40% income bracket who typically run micro or informal businesses. Many of them face daily struggles, limited access to capital, minimal exposure to training, and poor digital infrastructure (Ab Rahman & Raman, 2024; Busari, et. al., 2025). Despite this, they play an important role in local economies, especially in rural and semi-urban areas.

For Muslim entrepreneurs within this group, faith plays a central role in how they conduct business. Their decisions are often shaped by religious values, family responsibilities, and community ties (Dogan Gursoy, 2017). However, many available digital tools and support systems do not speak directly to their context. Studies have shown that religiously grounded training, Shariah-compliant financial products, and community-based digital literacy programs can significantly increase engagement (Gümüşay, 2015). These entrepreneurs aren't resistant to change; they simply need resources and solutions that reflect their values and realities. A Maqasid Shariah-based approach could offer them a more meaningful path forward, combining ethical integrity with practical empowerment. Addressing their needs isn't just an economic issue; it's also a matter of social justice, inclusivity, and respect for their identity.

2.4 Islamic Ethics

Islamic ethics is rooted in the core teachings of the Qur'an and the Sunnah, offering a moral framework that shapes how Muslims think, behave, and make decisions. It emphasizes values like justice, honesty, mercy, and trust, not only in personal conduct but also in business, governance, and public life. What sets Islamic ethics apart is its deep link between moral behavior and spiritual accountability; doing the right thing is both a social duty and an act of worship (Bhat, 2024).

In today's digital world, where innovation often outpaces regulation, ethical guidance is more important than ever. For Muslim users and entrepreneurs, digital platforms must respect values like fairness, privacy, and transparency (Fred et al., 2025). Concerns over exploitative practices, unethical marketing, or ambiguous financial transactions are common, and many seek tools and services that align with their beliefs. Embedding Islamic ethics into digital systems, whether in e-commerce, fintech, or education, can help build trust, encourage participation, and promote responsible use (Yegon, 2023). For communities like the B40, who often feel left behind, this ethical grounding offers both relevance and reassurance. By merging Islamic values with modern technology, we can support digital inclusion that is not just effective, but also dignified and just.

3. Research Methodology

The data were analyzed using thematic analysis, guided by Braun and Clarke's (2006) six-phase approach: (1) familiarization with the data, (2) generating initial codes, (3) searching for themes, (4) reviewing themes, (5) defining and naming themes, and (6) producing the final report.

The FGD data set was transcribed verbatim and read multiple times to gain a comprehensive understanding of the content. Manual coding was employed to identify meaningful units of data related to the research objectives. Codes were then grouped into categories and refined into broader themes.

A combination of deductive and inductive approaches was used. The deductive element involved using the five objectives of *Maqasid al-Shariah*: protection of religion (*Hifz al-Din*), intellect (*Hifz al-'Aql*), wealth (*Hifz al-Mal*), lineage (*Hifz al-Nasl*), and dignity (*Hifz al-'Ird*); as an initial analytical lens. For instance, financial literacy and inclusion initiatives were placed under *Hifz al-Mal*, Shariah-compliant transactions under *Hifz al-Din*, and digital literacy under *Hifz al-'Aql*.

The inductive process allowed new insights and sub-themes to emerge organically from participants' perspectives. For example, the idea of mandatory street vendor registration arose from policy concerns, while linking zakatability to digital adoption and charity-driven abundance surfaced from participant reflections. These were later mapped back to the Maqasid framework.

The thematic analysis revealed a range of strategies rooted in Islamic values, including ethical digital practices, trust-building in fintech tools, integration of religious teachings, and community-based digital literacy efforts. These themes provide a foundation for a values-driven framework to support digital adoption among B40 Muslim entrepreneurs.

No	Informant	Gender	Highest Qualification	Specialization
1	AJ	Female	Degree	Social entrepreneur and SME trainer
2	AS	Male	PhD	Education and information technology
3	AK	Female	PhD	Islamic Finance and <i>Maqasid Shariah</i>
4	MM	Male	PhD	<i>Maqasid Shariah</i> Principles
5	YS	Male	PhD	Islamic Finance and <i>Maqasid Shariah</i>
6	FS	Female	PhD	Academic & entrepreneurship
7	NA	Female	PhD	ICT
8	SM	Male	PhD	Islamic finance & IT
9	HZ	Male	PhD	Islamic Finance and <i>Maqasid Shariah</i>
10	NS	Female	PhD	Academic & SME Women's empowerment

This research drew on the insights of ten informants representing different fields, including Islamic finance, Maqasid al-Shariah, ICT, entrepreneurship, and education. The data was collected through focus group discussions, which were recorded, transcribed word-for-word, and carefully reviewed. Analysis followed Braun and Clarke’s (2006) six-phase thematic approach. Initial coding was done manually, then grouped into categories and broader themes. The process combined deductive reasoning, using the five objectives of Maqasid al-Shariah as a guiding framework, with inductive exploration to capture fresh perspectives. The diversity of participants enriched the study, producing themes on ethics, trust, religious values, and digital literacy.

The focus group discussions were conducted only with **experts** in Islamic finance, Maqasid al-Shariah, ICT, entrepreneurship, and education. They were not B40 entrepreneurs but were chosen for their knowledge and professional experience in issues affecting this group. The questions were designed to capture their expert perspectives on digital adoption challenges, strategies for improvement, and the role of Maqasid al-Shariah in shaping solutions.

4. Results

Thematic analysis was used to process the qualitative data obtained from the focus group discussion (FGD). This method was chosen to extract meaningful insights related to the research questions and to identify recurring patterns in participants' responses (Nyumba et al., 2018). The analysis followed the five-step process proposed by Braun and Clarke (2006), which includes: (1) familiarization with the data, (2) generating initial codes, (3) searching for themes, (4) reviewing and defining themes, and (5) producing the final report. In this context, a theme refers to a significant idea or pattern in the data that addresses the core objectives of the study.

The coding process began with descriptive coding, as guided by Morse and Richards (Watts, 2017), by identifying key phrases, words, and sentences from the transcribed FGD data. These codes were organized under three main elements: the causes of low digital adoption, strategies to improve digital engagement, and the role of *Maqasid al-Shariah* in supporting digital transformation. The analysis was conducted manually by closely reading the transcripts and categorizing responses based on conceptual relevance. Selected excerpts are presented to support key findings and highlight expert perspectives on the strategic role of a Maqasid-based framework.

(4.1) Theme one: Strategies for fostering a positive attitude towards digital adoption among B40 Muslim entrepreneurs. The government should impose sanctions on non-digital adopters

i. Mandatory Registration for Street Vendors

An expert suggested that policymakers should mandate the registration of street vendors, implying that such measures could help formalize their business operations. While this approach emphasizes the importance of compliance and oversight, it may also evoke concerns about enforcement and the potential resistance from entrepreneurs who may view it as burdensome. This can be illustrated thus:

[.....] *“I guess maybe the policymaker can use the approach of imposing on all those who sell on the streets to register their business, they like it or not, they need to be registered and I mean this is something that”* [AJ].

ii. Promoting Awareness and Incentivizing Compliance

As against the notion of enforcement compliance, advocating for an awareness-driven approach is also opined as a better approach. By promoting understanding and providing incentives, such as linking access to funding with the use of digital technologies, policymakers can encourage entrepreneurs to adopt digital tools voluntarily. This strategy emphasizes collaboration rather than coercion, potentially leading to more positive attitudes toward digital adoption. This can be evidenced by:

[.....] *“I think if we don't like to use the term to force them, but rather to spread awareness, maybe we can set a few rulings like for example, if you want to get some funding, you have to use digital technologies for instance. That will encourage them, rather than force them to this kind of new deployment”* [AK] & [NA].

iii. Financial literacy training for the B40 entrepreneurs

The FGD highlights the Malaysian government's commitment to financial inclusion, emphasizing the need for simplified initiatives. It underscores the role of government in enhancing access to financial services, particularly for marginalized groups, and suggests that strategic efforts are essential for fostering economic equity and development. The excerpt below highlights the statement thus:

[....] *“Uh, because I think for the government to make it more to simplify it and the Malaysian Government, they have financial inclusion, what do you call it, agenda initiatives”* [HZ].

(4.2) Theme two: Applied Maqasid Shariah to enhance the digital adoption attitudes of B40 Muslim entrepreneurs. Promotion of Personality (Hifz al-Ird): Enhance digital literacy through high-quality, user-friendly platforms

i. Shariah-Compliant Financial Support

Maqasid, as an Islamic philosophy, is a guide towards the development of digital financial inclusion strategies for entrepreneurs. Hence, offering grants, low-interest loans, and subsidies is an effective mechanism to improve digital tool adoption among B-40 Muslim entrepreneurs. The role of Shariah-compliant financial activities in digital adoption is emphasized thus:

[.....] *“compliant digital tools to aid B40 entrepreneurs in accessing technology: Because maqasid is the Islamic philosophy of the Islamic religion, what the industry needs, and especially in this topic on financial inclusion, digital financial inclusion for entrepreneurs”* [YS].

ii. Technology use can ease methods of doing Business (Maqsad of Tayseer) to increase Income

The concept of Maqsad of Tayseer (facilitation), shows that Islam encompasses all aspects of life. They reference the concepts of HAJAH (needs) and Daruriyyāt (necessities), along with Rukhshoh (concessions), advocating for the use of technology as a means to fulfill these Islamic principles.

[....] *“Here the Maqsad of Tayseer is a facility and you can see Islam in all aspects of life. We have the concept of HAJAH and Daruriyyāt. We have a concept of Rukhshoh, which is a technology and is part of Rukhshoh we have that we need to utilize”* [HZ]. [SM].

iii. Digital Use and Zakatability for Community Empowering

Emphasizes the importance of zakat in community empowerment, linking it to the transition from poverty to wealth. They advocate for developing actionable plans within a framework that supports this goal, highlighting the need for benchmarks in measuring success. This view is evidence-based on the quotation:

[....] *“There is a need to know when they can pay the zakat. The zakat institutions should have rubrics of what the benchmark is to determine who is zakatable among the B-40. This relates to community empowerment and moving from poverty to some kind of richness, so we have to develop actionable plans within them across its framework”* [FS].

(4.3) Theme three: Promotion of Religion (ad-Deen): Provide digital content and apps aligned with Islamic values, such as prayer times, Quran reading, and finance education:

- i. **Promote Equity in Wealth Sharing**
Discusses the Islamic perspective on wealth and sharing, stressing the responsibility to care for those in need. They point out the social and economic issues arising from neglecting those who have less, advocating for a more equitable distribution of resources. The excerpt below evidences the potential of equity in sharing wealth to digital adoption:
[.....] *“The concept of wealth sharing according to Islamic teachings emphasized the responsibility of being concerned about those who are been left out financially, or someone who has more wealth than he's needed, and neglecting others and things as social and economic problems that we have nowadays”* [AK]. [NS].
- ii. **Shariah Compliance Business is Essential for Digital Financial Transactions**
The awareness and practice of Shariah compliance business can boost the digital financial literacy of the B-40 Muslim entrepreneurs by educating them on ethical practices and providing resources, trust, and networking opportunities. This includes the need for entrepreneurs to use Shariah-compliant accounts for digital transactions, and ensuring that financial practices align with Islamic principles. This quotation below highlights the strategic impact of Shariah compliance business on digital adoption.
[.....] *“One is the Shariah compliance of the activities run through any digital platform, whether a digital financing, digital service, or even when we say digital financial inclusion, uh, we need to tell these entrepreneurs that you must have a Shariah-compliant account in an Islamic bank as a means of digital skill to receive and send payments”* [AS] [YS].
- iii. **Digital Use Increases Charity as a Path to Spiritual and Material Abundance**
Encourages Muslims to engage in charitable acts, noting that such actions yield rewards both materially and spiritually, contributing to increased wealth and benefits in this life and the hereafter. The following excerpt supports the statement:
[.....] *“That's why the Muslims were encouraged to do it because they are going to be rewarded one way or another, or either materially or physically, in this world, through the increase of their wealth through the increase of benefits, their benefits and returns, and also in the hereafter”* [MM].

5.0 Discussion of findings

The primary objective of this research is to explore the implications of Maqasid al-Shari'ah for integrated sustainability practices among businesses. Qualitative data was collected from Shari'ah scholars in Malaysia to achieve this goal. As outlined, the thematic analysis identified four key themes:

Theme 1: Encourage digital adoption through positive attitudes and possible government sanctions.

Theme 2: Enhance digital literacy (Hifz al-'Ird) via user-friendly platforms.

Theme 3: Promote Islamic digital content (Hifz al-Din) like prayer apps and finance tools.

5.1 Theme One: Strategies for Fostering a Positive Attitude Towards Digital Adoption among B40 Muslim Entrepreneurs

The digital divide among Malaysia's B40 Muslim entrepreneurs poses a significant barrier to equitable economic participation. One experts recommendation involves mandatory registration of street vendors, suggesting that formalizing informal businesses can foster digital engagement through policy enforcement. While this strategy enhances regulatory oversight, it raises ethical and practical concerns regarding autonomy and acceptance, especially when perceived as coercive. The study of [Devisakti et al. \(2024\)](#) also suggests that the study found that perceived usefulness, subjective norms, and all three gratification constructs significantly influenced digital usage among B40 students in Malaysian higher education institutions. In contrast, incentive-based strategies offer a more collaborative approach. Linking access to government funding or microfinancing schemes with digital platform usage encourages voluntary adoption. This aligns with behavior change theories that emphasize motivation over compulsion, fostering sustainable shifts in digital habits. [Li et al. \(2024\)](#), similarly contend that government incentives and collaborative strategies significantly enhance enterprise data resource sharing, maximizing benefits for all stakeholders and achieving Pareto optimality within the digital innovation ecosystem. Furthermore, financial literacy training emerged as a key enabling factor. Simplifying government-led financial inclusion initiatives for marginalized communities reflects an understanding of the socio-economic context of the B40 group. Enhanced literacy enables informed decision-making and empowers

entrepreneurs to navigate digital ecosystems confidently. This aligns with the findings of [Choudhary & Jain, \(2023\)](#) that financial literacy training programs can improve marginalized women's financial behavior and inclusion, though more context-specific research is needed to address regional challenges. Overall, this theme reflects a tension between top-down regulation and bottom-up empowerment, with a balanced approach likely yielding the most inclusive outcomes. However, [Devisakti et al. \(2024\)](#), found that perceived usefulness and subjective norms significantly influenced digital usage. Furthermore, all three gratification constructs positively affected digital usage, while perceived ease of use and perceived behavioral control were found to be insignificant. A recent systematic review argued that Cultural, religious, and social factors also play a major role, alongside performance and effect expectancy. Its novelty lies in classifying these determinants and integrating non-technical factors, offering a holistic, interdisciplinary perspective to enhance global e-government adoption ([Aleisa, 2024](#)).

5.2 Theme Two: Applied Maqasid Shariah to Enhance Digital Adoption Attitudes – Promotion of Personality (*Hifz al- 'Ird*)

This study found that the application of Maqasid Shariah, specifically the preservation of dignity (*Hifz al- 'Ird*), offers a values-based framework to enhance digital adoption among Muslim entrepreneurs. Providing Shariah-compliant financial support, such as grants, low-interest loans, and subsidies, addresses both material needs and religious sensitivities. These instruments serve as faith-based motivators for embracing digital tools and financial services. The study by [Afridi \(2016\)](#), also suggests the dire need for a renewed understanding of Maqasid al-Shari'ah to correct misconceptions about Islam and highlight its alignment with universal human rights and justice.

Further, the principle of Tayseer (facilitation) reflects Islam's inclusive approach to technology adoption. By recognizing Rukhsah (legal concessions), technology can be seen as a legitimate means to meet the necessities (*Daruriyyat*) and needs (*Hajah*) of life. This perspective reframes digital platforms as instruments of religious ease rather than mere economic tools. Finally, the integration of zakatability benchmarks underscores the connection between digital financial inclusion and community empowerment. By equipping B40 entrepreneurs with the means to become zakat payers, digital adoption becomes not just an individual upliftment strategy but a collective pathway toward socio-economic transformation. Such strategies reinforce the ethical, communal, and spiritual dimensions of Maqasid-driven digital inclusion. [Ahmed et al. \(2024\)](#); [Mansor \(2016\)](#), also concur on the necessity of a balanced, moderate, and maqasid-oriented approach in applying Islamic principles, highlighting the risks of misinterpretation and the importance of aligning contemporary practice with authentic Shari'ah understanding. The significance of information technology to human life cannot be overemphasized; however, [Aniq et al. \(2024\)](#); [Kholish et al. \(2020\)](#), posit that digital must be guided by the principles of Maqasid al-Shari'ah, preserving religion, life, intellect, progeny, and wealth to ensure it truly serves the public interest (*maslahah*) in line with the Qur'an and Sunnah.

5.3 Theme Three: Promotion of Religion (*Hifz al-Din*) through Islamic Digital Content and Ethical Finance

Religious identity plays a vital role in shaping digital behavior among Muslim entrepreneurs. Promoting Islamic digital content, such as apps for Quran reading, prayer times, and zakat calculators, supports the *Hifz al-Din* objective, preserving faith through meaningful engagement in the digital space. Beyond content, the emphasis on Shariah-compliant financial practices ensures ethical alignment in digital transactions. Encouraging the use of Islamic bank accounts and halal fintech platforms helps build trust among B40 entrepreneurs and reinforces religious accountability in financial dealings. This is congruent with the finding of [Nurfritria \(2023\)](#), that millennial Muslims in Indonesia are driving a communal socio-religious movement through social media, forming a new religious identity centered on Islamic practices and digital da'wah. This directly contributes to higher digital literacy and responsible financial behavior. Finally, the discussion around charity as a form of digital engagement ties material success with spiritual reward. Digital channels facilitate sadaqah and zakat, promoting not only increased giving but also a deeper connection to community values. [Abdallah et al. \(2025\)](#), also explicate that there is an increasing number of millennial Muslims who are driving a communal socio-religious movement through social media, forming a new religious identity centered on Islamic practices and digital da'wah. This integration of ethical finance and spiritual consciousness enriches the digital experience for Muslim entrepreneurs, enhancing their motivation to participate in the digital economy. [Busari and Sitiris \(2024\)](#); [Rosidi et al. \(2022\)](#) also found that Maqasid al-Shari'ah provides a suitable ethical framework for social media use, effectively guiding behavior, minimizing harm, and ensuring responsible technology adoption in

society.

Practical Implications

This study offers clear directions for improving digital adoption among B40 Muslim entrepreneurs. One key finding is that incentive-driven approaches are more effective than coercive policies. For instance, tying access to microfinancing or government support to the use of digital tools encourages entrepreneurs to participate willingly rather than reluctantly. At the same time, strengthening financial literacy and training equips them with the confidence needed to navigate digital platforms. Another important contribution lies in the role of Shariah-compliant financial instruments such as grants, interest-free loans, and subsidies. These not only provide material support but also reinforce trust, as they are consistent with Islamic ethical values. Finally, the development of Islamic digital platforms, whether prayer apps, zakat calculators, or halal fintech services, connects technology with faith and identity. By making digital tools relevant to their daily spiritual and business lives, adoption becomes more natural and sustainable.

Theoretical Implications

On the theoretical level, the research demonstrates how Maqasid al-Shariah can enrich technology adoption theories. While models like TAM or UTAUT emphasize usefulness and ease of use, this study shows that religious and ethical motivations also shape digital behavior in Muslim contexts. In particular, the principles of *Tayseer* (facilitation) and *Rukhsah* (concession) provide a fresh lens for understanding why technology can be seen as a tool that supports both necessities and higher objectives of Shariah. This repositions digital adoption as not merely an economic act but also a religiously meaningful one. By doing so, the study advances the idea of a Maqasid al-Shariah-based framework for digital inclusion, which can be tested in future research and applied across different Muslim-majority societies.

6. Conclusion and Recommendation

This study concludes that Maqasid al-Shariah-based strategies provide a comprehensive and ethically grounded framework for enhancing digital adoption among B40 Muslim entrepreneurs in Malaysia. By aligning technological engagement with the higher objectives of Shariah, particularly *Hifz al-'Ird* (preservation of dignity) and *Hifz al-Din* (preservation of religion), digital inclusion can be transformed from a purely economic goal into a spiritually and socially meaningful endeavor.

The research contributes to the theoretical expansion of Maqasid al-Shariah by contextualizing its application in digital transformation and financial inclusion. Future studies should further develop a Maqasid al-Shariah-based digital inclusion model by integrating concepts like *tayseer* (facilitation), *rukhsah* (legal concessions), and *zakatability* into behavioral adoption theories such as the Technology Acceptance Model (TAM) and the Theory of Planned Behavior (TPB).

Practitioners and development agencies should design Shariah-compliant financial tools, such as halal microfinancing, digital zakat platforms, and Islamic entrepreneurship training, tailored to B40 entrepreneurs. Financial literacy programs must incorporate religiously grounded content to build trust, boost confidence, and promote sustainable digital usage. Promoting Islamic digital apps, ethical fintech, and online religious learning platforms can further strengthen both digital capabilities and spiritual identity.

Policymakers should adopt a balanced approach between regulation and facilitation. While formalizing informal businesses is necessary, digital adoption policies must emphasize inclusivity and voluntarism rather than compulsion. Government incentives should be tied to digital platform use, with simplified access to Shariah-compliant funding mechanisms. Additionally, zakat institutions and Islamic councils should integrate digital entrepreneurship into their empowerment programs, ensuring that religious and economic goals are addressed concurrently. Overall, a maqasid-oriented digital adoption strategy ensures that economic participation among B40 Muslim entrepreneurs is inclusive, sustainable, and rooted in Islamic ethical values. The proposed Maqasid al-Shariah-based strategies are promising, but their real efficiency for B40 entrepreneurs is yet to be tested. Future studies should assess their practical impact to ensure they are not only ethical but also effective.

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