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ISLAMIC BANKING

Growth, Stability and Inclusion

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Palgrave CIBFR Studies in Islamic Finance

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CHAPTER 1

Empirical Research in Islamic Banking: Past, Present, and Future

Nafis Alam and Syed Aun R. Rizvi

Abstract Islamic banking is an emerging research theme in banking-related studies that can be further expanded owing to a dearth of extensive studies in this field. A major part of the literature contains a comparative analysis of Islamic banking and its conventional counterparts, based on performance and regulatory theme. The aim of this chapter is to demonstrate the extra-ordinary potential and depth of current and future research theme in Islamic banking domain. The chapter discusses the areas and issues that have been covered intensively in the recent literature, and also helps to identify the areas that have received relatively less attention. Finally, it also points to the newest areas of research that seem promising for future research in Islamic banking theme.

Keyword Islamic banking · Research · Comparative analysis · Regulation · Efficiency

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1 Introduction

Islamic banking and finance has emerged as an intriguing field of research in academia over the past decade. Islamic countries primarily straddle the developing and the less developed strata of the global economic society.

With financial assets valuing nearly $1.8 trillion globally Islamic banking and finance has started to gain traction within Muslim and non-Muslim financial markets over the last decade. The ever-increasing intensity of recurring financial crises, evidenced in the recent financial meltdown of 2007–2008, has put much pressure on the conventional financial system and brought it under the microscope yet again. While some have looked at ways and means to fix the instability inherent in the conventional interest-based system, others have searched for alternative financial systems. In this respect, the Islamic financial system seems to offer a promising avenue for future financial resiliency and stability. However, to date, this view has been largely circulated within professional circles and it has only recently become a topic of academic inquiry.

The room for exploration in Islamic banking and finance is huge, owing to a continuing dearth of extensive studies in this field. A major part of the academic literature on the subject contains a comparative analysis of Islamic financial system and its conventional counterparts, divided between banking and capital markets. Some studies also focus on the instruments used in the Islamic and commercial banking, and discuss the regulatory and supervisory challenges related to Islamic banking (e.g., Sundararajan and Errico 2002; Ainley et al. 2007; Jobst 2007; Sole 2007).

In this survey, we focus on the two main aspects of research in Islamic banking and finance: the banking sector and the capital markets. While not claiming to survey all literature on Islamic finance, which is too vast to cover in its entirety, we aim to demonstrate the extraordinary potential, and depth of research available and possible in the field. To do this, we undertake an exploration of the Thomson Reuters ISI Web of Knowledge and other journal search and ranking methodologies, including the SCImago Journal & Country Rank (SJR) measures, to identify the main journals in which significant literature on Islamic banking and finance has been published. In Sect. 3, we point to the newest areas of research that seem promising for future research and conclude our brief review of Islamic financial literature.

Islamic financial institutions operate in approximately 75 countries, mostly in the Middle East and Southeast Asia, with Bahrain and Malaysia as the major hubs. Islamic financial products have mushroomed over the past decades in competition to the conventional financial industry in both Muslim dominated and Muslim minority countries. As it is a niche industry, the Islamic financial industry is becoming a market that could rival the conventional sector in many countries. Dusuki and Abdullah (2007) described the Islamic financial sector as no longer a business entity operated only to fulfill the religious obligations of the Muslim community, but more significantly, it is striving to fulfill the needs and demands of new customers as well (as cited in Wilson 1995).

The growth in Islamic financial services has attracted much attention from across the world, and nearly 25 % of Islamic financial institutions now operate in countries that do not have Muslim majorities, while the conventional banking system has started opening Islamic banking windows across the world, primarily in Europe and North America (Pollard & Samers 2007).

The initial attempts at introducing Islamic finance in the Western world were initiated by the Islamic Finance House established in 1978 in Luxembourg. There is also the Islamic Bank International of Denmark in Copenhagen, and the Islamic Investment Company in Melbourne, Australia. Shanmugam, Perumal and Ridzwa (2004) observed that a tremendous effort has been progressing over the last decade in introducing Islamic financial services in Western countries, especially in the UK, Australia, and the US.

2 Islamic Banking Research: Past and Present Trend

Islamic banking growth has helped develop interest in studying the performance of Islamic banks through comparative analyses in recent times. The findings of most studies provide contradictory results in determining whether Islamic banks are better performers or not. An earlier work by Olson and Zoubi (2008) found Islamic banks to be more profitable, but less efficient as compared to their conventional counterparts over the 5-year period of 2000–2005. Their sample set comprised banks from the Gulf Cooperation Council (GCC), and the main investigation was carried out with financial ratios as the distinguishing factor between conventional and Islamic banks. In a more recent study, Abedifar, Molyneux and Tarazi (2013) found Islamic banks to be more capitalized

and profitable compared to conventional banks on an average while investigating risk and stability features of Islamic banking, using a large sample of 553 banks from 24 countries between 1999 and 2009. An interesting aspect of their finding points toward the smaller Islamic banks, which are more leveraged in predominantly Muslim countries and have lower credit risk than conventional banks.

In related research, Srairi (2010) compared conventional and Islamic banks using a frontier analysis approach for 71 commercial banks in the GCC over the period 1999–2007. He found that, in terms of both cost and profit efficiency levels, the conventional banks are more efficient than Islamic banks. Khediri, Charfeddine and Youssef (2014) reaffirm the results for the GCC using the period of 2003–2010 for investigating the performance of Islamic banks using near discriminant analysis, logistic regression, tree of classification, and neural network. They found that Islamic banks are, on average, more profitable, more liquid, better capitalized, and have lower credit risk than conventional banks, while they are also less involved in off-balance sheet activities and have more operating leverage than their conventional peers.

An aspect of financial literature in the firm-level banking studies falls under the field of cross-country analysis of Islamic banking and financial efficiency. The existing studies in this field can be broadly categorized into two groups: First, studies that group the Islamic banks based on geographical boundaries (e.g., Yudistira 2004; Sufian 2006), and the second classification compares the efficiency of Islamic banks with their conventional counterparts (e.g. Hassan et al. 2009; Ahmad and Abdul-Rahman 2012; Al-Khasawneh et al. 2012; Gishkori and Ullah 2013). While doing a comparative analysis of the efficiency and performance, some authors also extend into the determinants of these efficiency measures. The following discussion highlights some of the main studies from these two groups.

In the first classification, one of the earlier studies by Yudistira (2004) explored the performance of 18 banks from the Middle East, East Asia, and African countries, for a short period of 1997–2000. Using a nonparametric approach of Data Envelopment Analysis (DEA) the study analyzed the technical and scale efficiencies of the Islamic banks. The results argued that the slight inefficiencies experienced by the Islamic banks during the crisis of 1998/1999 can be explained by pure technical inefficiency rather than scale inefficiency. The main contributor to scale efficiency was bank size according to Yudistira (2004). The findings of the study also highlighted that the risk-taking

behavior of the Islamic banks across different regions does not have a significant effect on the overall technical efficiency of these Islamic banks.

While examining the efficiency of Malaysian Islamic banking through the period 2001–2005, Sufian (2006) suggested that the scale inefficiency dominated pure technical inefficiency in the Malaysian Islamic banking industry. In addition, he also found domestic Islamic banks to be marginally more efficient compared to foreign Islamic banks.

Expanding the earlier works, Sufian and Noor delved into a comparative analysis of the efficiency of Islamic banking sectors in the Middle East and Africa (MENA) and Asian countries to investigate the technical, pure technical, and scale efficiency for each bank during the period 2001–2006. Their findings suggest that the MENA Islamic banking industry exhibits higher mean technical efficiency relative to the Asian Islamic banks. The pure technical inefficiency outweighed the scale inefficiency in both MENA and Asian banking sectors, and the banks of MENA countries were found to be global leaders that dominated the efficiency ratings during the period of study.

In a very recent study by Rosman, Abd Wahab and Zainol (2014), the results highlighted the fact that Islamic banks were able to sustain operations through the crisis by studying the case for 79 Islamic banks across the Middle East and East Asia for the global financial crisis period of 2007–2010. However, most of the banks were scale inefficient, while profitability and capitalization were the main determinants of Islamic banking efficiency. This has been further corroborated by Belanes et al. (2015), who studied the three aspects of efficiency, namely overall technical efficiency, pure technical efficiency, and scale efficiency, for the GCC-based Islamic banks and found that most Islamic banks have remained efficient, whereas some of them witnessed a relatively minor decrease in their efficiency level. They argue that Islamic banks have succeeded in mobilizing large amounts of deposits, especially when the impact of the crisis has been devastating to the managers of global finance.

In the second classification of Islamic and conventional banking analysis, Hassan, Mohamad and Bader (2009) investigated the difference in mean cost, revenue, and profit efficiency estimates of Islamic versus conventional banks. Encompassing 11 Islamic countries and 40 banks, for an extended period of 15 years, starting from 1990, their study highlights that there was no significant difference between the overall efficiency of the Islamic banks and the conventional banks.

In contrast to the results of Hassan et al. (2009), Ahmad and Abdul-Rahman (2012) examined the relative efficiency of the Islamic and

conventional banks in Malaysia between 2003 and 2007. Their findings negate the previous findings, and the conventional banks outperformed the Islamic commercial banks in all efficiency measures, indicating that this higher efficiency may be owing to managerial efficiency and technological advancement. Al-Khasawneh, Bassedat, Aktan and Thapa (2012) while examining the same argument in the case of North Africa for almost a similar time frame from 2003 to 2006 indicated that the Islamic banks achieved higher average revenue efficiency scores compared to the conventional banks in the region. However, they also highlighted that the growth of efficiency measure was relatively slower for Islamic banks as compared to their conventional counterparts.

In a study specifically on Pakistan, a Muslim majority country of 180 million, Gishkori and Ullah (2013) argued that the technical inefficiency for the Islamic banks is primarily owing to the scale inefficiency instead of pure technical inefficiency. In a large dataset study, Beck, Demirguc and Merrouche (2013) investigated 510 banks across 22 countries with 88 Islamic banks, during the period 1995–2009. They found that Islamic banks were less efficient, but have higher intermediation ratios, have higher asset quality, and are better capitalized than conventional banks. Their findings also suggest that Islamic banks perform better during crises in terms of capitalization and asset quality and are less likely to disintermediate than conventional banks.

A recent study by Rosman et al. (2014) highlighted the fact that Islamic banks were able to sustain operations through the crisis for a sample set of 79 Islamic banks across the Middle East and East Asia for the global financial crisis period of 2007–2010. However, most of the banks were scale inefficient while profitability and capitalization were the main determinants of Islamic banking efficiency. A comprehensive study by Johnes, Izzeldin and Pappas (2014) of 252 banks (207 conventional and 45 Islamic) across 18 countries found Islamic banks to be on similar grounds with their conventional counterparts in terms of gross efficiency. However, differences exist in the efficiency where Islamic banks are higher while significantly lower on type efficiency. They argue that the low efficiency of Islamic banks could be attributed to lack of product standardization whereas high net efficiency reflects the high managerial capability in Islamic banks.

Some recent studies have diverged from the performance and efficiency issues in Islamic banking, and also studied the competitiveness of Islamic banking industry. Despite the reality that Islamic banks will grow rapidly in today's economy, there are a few systematic and regular analyses on the topic

of the competition in Islamic banking. The majority of the previous studies only focused on the comparison of banking performance, such as the comparison of cost–profit efficiency and financial stability in dual-banking systems, for example, the studies provided by El-Gamal & Inanoglu (2005), Cihak and Hesse (2008), and Alam (2012a). Turk Ariss (2010) found that Islamic banks are relatively less competitive than their conventional counterparts in 13 countries during the period 2000–2006. They argue that it may be because Islamic banks allocate a greater share of their assets to financing activities compared to conventional banks.

Turk Ariss' (2010) findings were contradicted by Weill (2011) who argues that Islamic banks by no means are less competitive. Weill (2011) focused on the analysis of market power in both conventional and Islamic banks by using a cross-country sample of 17 countries from the Middle East and South East Asia to determine whether Islamic banks had higher market power than conventional banks over the period 2000–2007. The result showed that Islamic banks have lower market power than conventional banks resulting from the nature of Islamic banking concept that forbids the banks to charge interest and limit their ability to charge on high prices on their financial products. In fact, in robustness checks with control variables, some of the results suggest a higher competitiveness. His sample set contains 17 countries arranging from 2000 to 2007. Weill (2011) argues that while the competitiveness may be same, market power of Islamic banks may be low that can be attributed to their different norms and their different incentives. One such area would be the impact of the competition on the risk-taking behavior of the Islamic banks.

Sahut, Mili and Krir (2011) conducted a study on the factor of competitiveness of Islamic and conventional banks in the MENA region and the effect of competition on banks' profitability. Their study used PR-H statistic of Panzar and Ross and Lerner index to measure the competition in dual-banking systems and found that conventional banks are less competitive than Islamic banks. Moreover, Islamic banks also tend to have higher market power over the conventional banks.

Although studies conducted by Weill (2011), Sahut et al. (2011), and Turk Ariss (2010) focused on the comparison of market power between Islamic and conventional banks, these studies did not cover any comparative association between competition and risk-taking behavior among Islamic and conventional banks, which is one of the areas to be considered for future investigation.

Another area that demands an extensive investigation is the regulatory framework for the effective operation of Islamic banking system.

Regulations and the supervision of the banking system have been the topic of much recent discussion and attention, mainly because of the global financial crisis of 2007. Regulatory frameworks play an important role in the efficiency, risk-taking behavior, and financial stability of the Islamic banking system.

Alam (2012a) estimated profit and cost-efficiency of 70 Islamic banks and 165 commercial banks and compared them with the risk-taking behavior of these banks. Using data from 2000 to 2010, he established that for conventional banks, there is a positive relation between risk and inefficiency whereas as the opposite holds true for the Islamic banks. Conventional banks with low efficiency were found to have a high risk appetite, whereas inefficient Islamic banks cannot take greater risks because of the controlled costs. Results showed that larger Islamic banks have higher cost and profit efficiency. Alam (2012a), further suggested that for dual-banking systems, regulators should make sure that Islamic banks are highly capitalized in order to remain efficient.

In a related study, Alam (2012b) studied the impact of regulatory and supervisory framework associated with Basel III's pillars with risk taking and efficiency in the dual-banking system. He found that technical efficiency of Islamic banks is improved by stringent regulations and monitoring of banks and greater supervisory power. However, the opposite effect was found among conventional banks. Regarding risk-taking behavior of banks, it was found that conventional banks tend to take greater risks when severe restrictions are placed on their activities, whereas, Islamic bank's risk taking goes down with higher restrictions. In his recent study focusing on regulatory factors and risk taking of Islamic and conventional banks, Alam (2014) established that strict capital requirements results in controlled risk-taking actives by both Islamic and conventional banks. With official supervision as a regulatory tool, the study found that it had a similar effect on the risk-taking behavior of both conventional and Islamic banking system. The author argued that Islamic banks tend to work better with stringent regulatory environment as compared to their conventional counterparts, furthermore, establishing that Islamic banking system is better prepared for implementing Basel III guidelines.

Although there are not many studies on the incentive structure of Islamic banks, recently, Farook, Hassan and Clinch (2014) explored incentive and loan loss provision and their overall results suggest that there is an inverse relationship between profit distribution management and loan loss provisions. The results also suggest that there are differential effects

depending on whether the profit distribution management is for the benefit or the detriment of investment depositors. Their results are derived from 248 Islamic banks and 2258 conventional banks with a minimum of 5 years and a maximum of 10 years of data for each bank for the period 1992–2005. Recently Azmat, Skully and Kym (2015) found that adverse selection and moral hazard alone cannot explain this phenomenon while investigating the dominance of debt natured contracts on the asset side of Islamic banks argue. They augment the model with risk-averse depositors to highlight that asset side Islamic Joint Venture (IJV) could be deterred by Islamic banks' liability side. They conclude that for IJV, venture capital and private equity will prove to be more successful institutions than banking.

In a pioneering work on Islamic banks' capital buffers, Daher, Masih and Ibrahim (2015) investigated the susceptibilities of Islamic banks' capital buffers to unique risks emanating from their operating environments. Employing two-step dynamic Generalized Method of Moments on a dataset comprising 128 conventional and Islamic banks, they argued that privately owned Islamic banks, unlike their state owned counterparts, attempted to safeguard shareholders by independently mitigating the effects of displaced commercial risk through higher capital buffers. In addition, their findings suggested that the relation between equity investment risk and bank capital buffers also seems to vary by region.

In related literature on Islamic banking, Mallin et al. (2014) compared corporate social responsibility (CSR) and financial performance of 90 Islamic banks across 13 countries. Using the CSR disclosure index, their findings suggest that Islamic banks engage across the range of social activities, on both individual and geographical group levels. But they seem to be paying less attention to environmental aspects while exhibiting more commitment to the vision and mission, the board and top management, and the financial product/services dimensions.

Bank stability is another dimension that needs a thorough investigation within the Islamic banking system. Studying Islamic banking from bank stability perspective is important as Islamic banks are becoming systematically significant due to their rapid growth and increase in their share of the global banking system. Additionally, the absence of hedging instruments in Islamic banks can cause greater risk among financial institutions. It has been discussed that the special features of Islamic banking should be recognized and disclosed in the application of efficient banking supervision and to acquire an optimal operation of Islamic banking according to their attributes. Cihak and Hesse (2008) were the first ones to study the

Islamic banking from the viewpoint of banking stability. They compared the stability of Islamic banks with conventional banks, using data from 18 countries for the time period of 1993–2004. The study established that small Islamic banks are more stable when compared to small conventional banks. However, large Islamic banks were found to be unstable when compared with large conventional banks, indicating higher credit risk management problems for large Islamic banks.

Beck et al. (2013) used a larger sample to study the conventional and Islamic bank's model, stability, and efficiency. They conclude that countries, where Islamic banks have a greater market share, also have unstable, yet more cost-efficient, conventional banks. They also established that the resilience of Islamic banks during global financial crisis of 2007 was due to the greater capitalization and liquidity reserves of Islamic banks. Studying the interrelationships amid bank efficiency, competition, and stability, Kristo and Gruda (2010) estimated different variables that influence bank's stability for the time period 2005–2009. Comparing nonperforming loans, net interest margin, *z*-score, and return on equity they concluded that the high level of competition can improve bank's efficiency but deteriorate its stability.

Although a few studies investigate bank's stability and regulations together among conventional banking system, regarding dual-banking system, there is no exhaustive study to investigate the three-way relationship between bank regulations, efficiency, and stability for the Islamic banking system.

3 Islamic Banking Future Research

It can be seen from the above discussion that there is an extensive empirical literature on the efficiency, performance, risk-taking behavior, and regulatory theme under the Islamic banking domain. Evidence suggests that Islamic banks have mixed bag results when compared to their conventional counterparts in the dual-banking system. There is little evidence that Islamic banks perform worse than their conventional counterparts or tend to be riskier or unstable during the economic downturn.

Much work needs to be done in the area of Islamic banking role in the economic and financial development. There is a dearth of literature when it comes to assessing the role of the Shariah Supervisory Board on issues such as earnings management for Islamic banks. Governance issues in the Islamic banks is an area that is yet to be explored given the complex nature of relationships among different stakeholders of Islamic banks. Work still

needs to be done on examining the systematic risks and unique risks for an Islamic bank. More specifically, it will be worth looking at the liquidity and market risk of Islamic banks.

Most of the research carried in the dual-banking system was done when Islamic banks were in their infancy and less affected due to global financial crisis. It would be interesting to see if Islamic banks are ready to face the challenge when their main location undergoes an economic downturn in light of falling oil prices.

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CHAPTER 2

Impact of Islamic Banking on Economic Growth and Volatility: Evidence from the OIC Member Countries

Mohsin Ali and Wajahat Azmi

Abstract Islamic banking has attracted attention in financial economics literature due to its fast-paced growth. Concurrently, there is established amount of literature that presents the positive impact of banking development on economic growth, which attracts attention and debates whether Islamic banking would also have a similar impact and how Islamic banking could impact the economic stability? To answer these questions, this chapter examines the impact of the development of Islamic banking on economic growth and volatility by using a sample of 21 OIC member countries having both Islamic and conventional banks for the period of 2007–2013. Results show that, even though Islamic banking is relatively smaller in size, it is found to be conducive to economic growth but does not impact economic volatility. We also found that Islamic banking is playing a complementary role toward conventional banking practices in the selected counties.

Keywords Islamic banking · Economic growth · Economic volatility

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1 Introduction

Islamic banking has emerged as an alternative to the conventional form of banking, and it has grown rapidly in the last three decades both in Muslim and non-Muslim countries. According to Iqbal and Mirakhor (1987) the concept of interest-free banking emerged in the late 1940s. The first attempt to start Islamic banking was done by Dr. Ahmed El Najjar in 1963 in Egypt and was called Mit Ghamr. This bank was built on the basis of profit sharing (Ariff 1988; Siddiqui 2001). Since then, Islamic banks have developed their foundation in more than 60 countries around the globe, and bankers forecasted that the Islamic banks can take over more than 50 % of deposits in Muslim majority countries (Ahmad and Ahmad 2004). As per E&Y's "World Islamic Banking Competitiveness Report 2016,"[1] the Islamic banking has grown from $490 billion in 2010 to $882 billion in 2014 and the growth rate was 16 % (as shown in Fig. 2.1).

Academic literature that examines the influences of Islamic banking on economic stability remains scarce. There are few studies that have discussed the impact on the macroeconomic level, wherein they have analyzed the differences in behavior of Islamic and conventional banks. But studies on the macroeconomic impact of Islamic banking have not been discussed much.

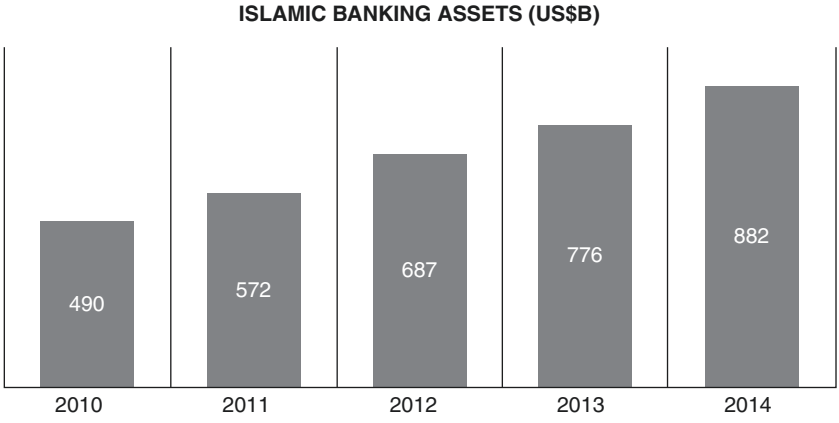

Fig. 2.1 Islamic banking assets

Generally economists differ about the role of the financial sector in economic growth. Bauer et al. (1984) ignored finance in their essays on development economics. Lucas (1988) described finance as an "overstressed" determinant of economic growth. Having said that, there is a group of researchers of similar caliber on the other extreme: Merton Miller (1988) argues that, "[the idea] that financial markets contribute to economic growth is a proposition too obvious for serious discussion" (p. 14). Illustrating a more constrained conclusion, Schumpeter (1912 [1934]), Gurley and Shaw (1955), Goldsmith (1969), and McKinnon (1973) discard the thought that the finance–growth relationship might be ignored without considerably restricting our understanding of economic growth.

The financial system plays a significant role for efficient allocation of resources in an economy. An efficient financial system promotes the vital function of financial intermediation through financial institutions (Mirakhor and Iqbal 2007). We tend to expand on an extensive number of studies that focus on the finance–growth relationship (King and Levine 1993; Rajan and Zingales 1998; Levine et al. 2000; Beck and Levine 2004; Bertocco 2008; Jalil et al. 2010; Rahaman 2011; Kendall 2012). It is generally regarded that the well-developed financial markets and intermediaries bring positive implications on economic growth by facilitating the allocation of capital to the real sector, enhance the allocation of resources, and support firms raise investment required. The banking sector is considered as the most important financial intermediary in an economy because of the part it plays as a provider of capital that facilitates economic growth. So, the question arises as to whether the development of Islamic banking impacts the economic stability of the OIC countries where Islamic banking is becoming a force. We tend to explore whether the impact of Islamic banking on the economic growth and volatility is different as compared to conventional banking. These research questions have major policy implications as the results would suggest that if the Islamic banking has a positive or negative impact on the economic stability. This would provide us the reasons to favor or check the expansion of Islamic finance. Answers to these questions would interest the financial regulators of all those countries where Islamic finance is growing.

In the next section, we briefly discuss Islamic banking. Then in the third section we will present a review of related literature followed by the data and descriptive statistics in Sect. 4 and Sect. 5, respectively. The empirical results are presented in Sect. 6. Finally, we conclude with Sect. 7.

2 Islamic Banking

In the previous section, we discussed the rapid growth of Islamic banking. In this section, we will elaborate on the concept of Islamic banking and how it is different from its conventional counterpart. Islamic banking is considered as an alternative form of banking. It is different from conventional banking in many ways. Conventional banks conduct their operations on the basis of predetermined interest rate-based borrowing and lending transactions. On the other hand, Islamic banks are financed by either non-interest bearing current accounts or by profit-sharing investment accounts (PSIA), which refers to a deposit product created for profit-sharing contract where the account holder and Islamic bank agree to share the profit on a pre-agreed profit-sharing ratio, generated from investments/assets financed by PSIA, while financial losses have to be borne by the account holder. On the asset side of balance sheet, an Islamic bank has a wide range of contracts that can be used such as markup sale (Murabahah), lease (Ijarah), profit-sharing (Musharakah and Muḍarabah), and fee-based services (e.g., Hawalah and Wakalah). All the banking transactions based on sale or lease are required to be asset-backed. This is dissimilar to the practices of the conventional counterparts where an asset is considered important when it is taken as collateral, it is mostly not part of a normal loan transaction.

Conventional banking has standard risks, whereas Islamic banking, due to its unique operations, gives rise to different risks specific to Islamic banks, like Shariah compliance risk, which arises when any of the Islamic banking practices found to be not compliant to Shariah regulations of that particular jurisdiction, mostly ex post. Then there is displaced commercial risk (DCR), which is defined as "the risk arising from assets managed on behalf of Investment Account Holders which is effectively transferred to the Islamic Financial Institutions own capital because the Institution forgoes part or all of its Mudarib's share (profit) on such fund, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to Investment Account Holder's" (IFSB 2005/2-Standard para76).[2] Another risk specific to Islamic banking is equity investment risk that originates from unique profit-sharing contracts that are not used in conventional banking.

In addition to that there are some other industry specific risks that are related to the nature of the business model and young age of the industry.

These include: difficulty in managing liquidity risk when there are inadequate or no Shariah compliant money markets and the Lender of Last Resort.

3 Literature Review

In this section we review studies addressing the relationship between Islamic banking and economic growth and volatility. As stated by Imam and Kpodar (2015), if we go by Modigiliani and Miller's capital structure irrelevance theory, Islamic banking is likely to have a similar impact on growth and stability as conventional banking if they finance same projects. However, though seemingly Islamic banks may perform similar functions as their conventional counterparts, they also have distinct features. Due to these distinct features Islamic banks might have a different impact on the economy as compared to their counterparts. Imam and Kpodar (2015) used the data from low and middle income countries for the period of 1990–2010 to study the impact of Islamic banking on growth. Their results indicate a positive relationship between Islamic banking and economic growth.

Al Bahar (1999) states that Islamic banking is important because it works as an intermediary system through which the population of the world can advantage from savings of the Muslims worldwide. According to him, Islamic banking is significant to the global economy because it can work with the conventional banking system. In addition, Islamic banking also takes care of the incapability of the conventional system to integrate Islamic markets into the world economy. In their study of the OIC member countries, Naceur et al. (2015) also emphasizes on the importance of riba-free banking in order to bring Muslim savings in the financial system.

Sadr and Yazdan (2012) used empirical results to demonstrate the impact of Islamic financing on economic performance. They studied both short and long-run relationships between development of Islamic banking and economic growth in Iran and Indonesia by using quarterly data from the first quarter of 2000 to the last quarter of 2010. They identified a significant bidirectional correlation between development of Islamic banking and economic growth both in the short and long run. Tabash and Dhankar (2014b) studied the relationship between the development of Islamic financing system and the economic growth in the United Arab Emirates (UAE). They used time series data from 1990 to 2010 to find the relationship. They found that financing by Islamic Banks

is a positive contributor to grow investments in the UAE in long run. Another article by Tabash and Dhankar (2014a) examines the relationship between the Islamic finance development and economic growth in Qatar. They observed that Islamic banks' financing is positively related to economic growth in Qatar in the long run. Furqani and Mulyany (2009) took the quarterly Malaysian data from the first quarter of 1997 to the last quarter of 2005 to study the dynamic relationship between Islamic banking and economic growth by using VECM. Their study concludes that in the short run, only fixed investment granger causes Islamic banking. While in long run, they have found a bidirectional relationship between Islamic banking and fixed investment.

Mohagheghniya et al. (2014) adopted an ARDL and a VAR approach to study the impact of different modes of Islamic bank financing on the Gross Domestic Product (GDP) of Iran during the period from 2000 to 2010. In their study, they found that different Islamic banking contracts have a significant positive effect on GDP of Iran. Gheeraert and Weill (2015) studied the influence of Islamic banking development on macroeconomic efficiency by using a sample of 70 countries for the period 2000–2005. They found that the development of Islamic banking favors macroeconomic efficiency. While examining the nonlinear relationship, the evidence suggested that an increase in the development of Islamic banking enhances macroeconomic efficiency only up to a certain level, and beyond this level the expansion of Islamic banking can affect the efficiency negatively.

There are studies which argue about the impact of Islamic finance on the financial stability. As per Smolo and Mirakhor (2010), Islamic banks do not possess balance sheet mismatches, as short-term deposit finance short-term trading and for longer term investments long-term deposits are used. Islamic banks have been found to be performing better in the recent financial crisis as compared to the conventional counterparts because of their better capitalization combined with higher liquidity reserves. Additionally, Islamic banks are not allowed to use derivatives and quite a number of other nontransparent products. Adding profits and loss sharing along, makes a better crisis prone system (Čihák and Hesse 2008; Hasan and Dridi 2010). According to Imam and Kpodar (2013), it is reasonable to conclude that dual banking systems (have both Islamic and conventional banks) are likely to contribute to financial stability.

Having discussed all the positive features Islamic banking brings to promote growth and stability, there are some disadvantages attached to it as well. Islamic banking is found to have lack of economies of scale and

liquid instruments. As per Moody's (2009), there is no secondary market for Islamic fixed-income products, forcing Islamic banks to have large liquidity buffers, putting them at a disadvantage relative to conventional banks. Second, Islamic banks are mostly younger and smaller than their counterparts, suggesting they are yet to reach the optimal scales and that is why they have higher cost structures (Hasan and Dridi 2010).

It can be seen from above that empirical evidence is required in order to see the impact of Islamic banking on economic growth and stability. Though there are a lot of empirical studies on the influence of financial development on growth, literature on how development of Islamic banking affects growth and stability is scarce. This chapter is an attempt to study the topic and fill the gap.

4 Data and Methodology

4.1 Data

We use two sets of data: measures of the development of banking and macroeconomic data. For banking data, we use Bankscope database. It is the most widely used database in empirical studies on Islamic banking (e.g., Čihák and Hesse 2008; Srairi 2010; Weill 2011). It covers a large number of financial institutions around the world and classifies banks on the basis of specialization as either Islamic or non-Islamic. First, we collected bank level data for 547 conventional and Islamic banks from 21 OIC member countries[3] that have both conventional and Islamic banks in their financial system with data spanning the period 2007–2013. We have left out Gambia, Maldives, Nigeria, and Oman because of the unavailability of banking data for most of the year. Second, we have summed it up to get country level aggregate Islamic and conventional banking data. Our main variable is the ratio of private credit offered by Islamic banks to GDP, which is a measure of the development of Islamic banking (ICREDIT). We follow Levine et al. (2000) in this regard, private credit is the financing that is given by banks to the private sector. So, we have obtained our variable by dividing each year's aggregate Islamic banking private credit of a country by the GDP of the respective country. GDP data are obtained from the World Development Indicators. Besides, we also include conventional banking development measures by dividing each year's aggregate conventional banking private credit of a country by the GDP of the respective country (CCREDIT) and also a measure of our overall banking development

(TCREDIT), which we get by dividing each year's aggregate private credit of a country by the GDP of the respective country.

We also use another measure as a proxy for the development of the banking sector. That measure is based on aggregate deposits to respective country's GDP. A number of works on the finance–growth nexus have used deposits as a proxy for banking development as well. As an example, Levine and Zervos (1998) focused on credit while studying the link between financial development and growth, but they also test deposits of banks to ensure robustness. For Islamic banking development of Islamic banking (IDEPOSIT), we divide Islamic banking deposit of a country to respective country's GDP. As earlier, we have also calculated and included similar measures for conventional banking deposits (CDEPOSIT) and total banking deposits (TDEPOSIT).

We have collected macro-level data from world development indicators provided by the World Bank. We have collected data on GDP growth as a measure of economic growth. Economic volatility is calculated as 3-year rolling standard deviation of GDP growth rate that allows capturing relationships between the variables in the medium term. We use two control variables in our estimations: inflation (INF) and openness (OPEN) to trade. These variables are chosen because these variables have been considered in former studies on finance–growth nexus. Second, these variables do not possess high correlation with the banking variables.

4.2 Methodology

The dependent variable is a measure of economic growth or volatility, respectively. So GDP growth and volatility will take place of dependent variables. For main independent variables we use different proxies of credit and deposit. In our estimations either we use TCREDIT/TDEPOSIT or both ICREDIT/IDEPOSIT and CCREDIT/CDEPOSIT. This study empirically examines the relation between economic growth or volatility measures and banking development (denoted by BDEV) by using the following dynamic panel data model:

$$\begin{aligned} Growth_{k,T} = {} & \left(1 + \alpha_{(Growth)}\right) Growth_{k,T-1} + \beta BDEV_{k,T} \\ & + \gamma Control_{k,T} + \epsilon_{k,T} \end{aligned} \tag{2.1}$$

$$Volatility_{k,T} = \left(1 + \alpha_{(Volatility)}\right) Volatility_{k,T-1} + \eta BDEV_{k,T} + \rho Control_{k,T} + \mu_{k,T} \tag{2.2}$$

where k and T refers to country number and time respectively. Growth refers to GDP growth (GDPG) and risk is measured by the standard deviation of GDP growth (SDGDPG). Finally, BDEV, the banking development indicators as mentioned above are TCREDIT/TDEPOSIT or ICREDIT/IDEPOSIT and CCREDIT/CDEPOSIT and Control is the list of control variables used in this chapter.

We follow the generalized method of moments (GMM) procedure in studies of Arellano and Bover (1995) and Blundell and Bond (1998), which associate the regression in differences with the regression in levels. Using the GMM estimator, the instruments for the level equation are the lagged differences of the corresponding variables, whereas the instruments for the difference equation are the lagged levels. The system GMM method is much more consistent and efficient in estimating the coefficients of the model and in solving the problems of endogeneity, heteroskedasticity, and autocorrelation (Arellano and Bover 1995). The dynamic panel technique is also helpful in amending the bias induced by omitted variables in cross-sectional estimates and the inconsistency caused by endogeneity.

5 Descriptive Statistics

Table 2.1 provides descriptive statistics for the variables that were used in the estimations. GDPG of selected the OIC member countries averages at 11.31 % and has a high level of volatility. The conventional deposit is on average about 74.35 % of GDP and the Islamic deposit is just about 13 % of total GDP based on the sample of 21 OIC member countries. As far as credit is concerned, the average conventional credit of selected the OIC member countries is about 45.44 % of GDP and Islamic credit is just about 10.01 % of GDP. Conventional credit is more volatile than Islamic credit and for a certain country in a certain year it has reached to the maximum of 216.73 % of GDP. Similarly, conventional deposit is also more volatile than the Islamic deposit and for a certain country in a certain year it has reached to the maximum of 393.10 % of GDP. The average inflation of these countries is around 6.21 %.

Table 2.1 Descriptive statistics

	CDEPOSIT	*CCREDIT*	*IDEPOSIT*	*ICREDIT*	*TDEPOSIT*	*TCREDIT*	*INF*	*OPEN*	*GDPG*
Mean	74.35	45.44	13.98	10.01	88.23	55.38	6.21	0.89	11.31
Standard Deviation	89.95	45.32	21.67	15.15	101.56	56.71	5.87	0.38	12.42
Minimum	0.66	0.18	0.15	0.00	1.02	0.27	−10.07	0.22	−28.15
Maximum	393.10	216.73	108.18	77.68	451.93	270.24	37.39	1.92	44.61

6 Empirical Findings and Discussions

We present our results in Tables 2.2 and 2.3. In Table 2.2, we have estimations using credit based banking development indicators and in Table 2.3 we have estimations using deposit based banking development indicators.

Table 2.2 shows us the impact of credit on economic growth and volatility. Columns 1 and 2 have log of GDP growth (LGDPG) as dependent variable whereas columns 3 and 4 have log of standard deviation of GDP growth (LSDGDPG) as dependent variables. In column 1, we have log of total credit (LTCREDIT) along with control variables as independent variables. Total credit seems to have positively impacted the economic growth of the OIC member countries. This finding confirms the results found in the finance-growth literature that financial deepening influences growth positively. The coefficient is positive and significant at 1 % significance level. In the second specification, where total credit was replaced with conventional (LCCREDIT) and

Table 2.2 Islamic credit, growth, and volatility

Dependent variable	*(1) LGDPG*	*(2) LGDPG*	*(3) LSDGDPG*	*(4) LSDGDPG*
L.LGDPG	0.116	0.311		
	(0.657)	(0.295)		
L.LSDGDPG			0.586***	0.614***
			(0.000)	(0.000)
LTCREDIT	2.094***		−0.152	
	(0.005)		(0.617)	
LCCREDIT		1.966**		0.00199
		(0.014)		(0.993)
LICREDIT		0.453**		−0.13
		(0.037)		(0.409)
LINF	1.055***	1.538***	0.315***	0.302***
	(0.000)	(0.001)	(0.003)	(0.005)
LOPEN	−0.584	−2.506	1.750***	1.582***
	(0.623)	(0.144)	0.000	(0.007)
_CONS	7.489**	4.18	9.795***	8.798***
	(0.023)	(0.128)	(0.000)	(0.000)
N	77	77	112	111

p-values in parentheses
** $p < 0.05$, *** $p < 0.01$

Table 2.3 Islamic deposit, growth, and volatility

Dependent variable	*(1) LGDPG*	*(2) LGDPG*	*(3) LSDGDPG*	*(4) LSDGDPG*
L.LGDG	0.193	0.148		
	(0.451)	(0.630)		
L.LSDGDPG			0.552***	0.572***
			(0.000)	(0.000)
LTDEPOSIT	2.557**		0.224	
	(0.015)		(0.466)	
LCDEPOSIT		1.671**		0.352
		(0.043)		(0.198)
LIDEPOSIT		0.403		−0.0596
		(0.414)		(0.856)
LINF	1.014***	0.907**	0.335***	0.342***
	(0.001)	(0.033)	(0.002)	(0.002)
LOPEN	−1.157	−1.229	1.547***	1.121
	(0.311)	(0.465)	(0.003)	(0.129)
_CONS	9.984**	7.055*	9.119***	8.282***
	(0.036)	(0.085)	0.000	(0.006)
N	77	77	112	111

p-values in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Islamic credit (LICREDIT), both conventional and Islamic banking were found to stimulate growth. This confirms the theoretical predictions, in spite of the fact that Islamic banking is small in relation to GDP (as discussed in descriptive statistics). This result advocates that both Islamic and conventional banking meet the particular needs of individuals and companies. But the coefficient of conventional banking credit is bigger than the coefficient of Islamic banking credit which might be due to its bigger size in terms of GDP. It also suggests that Islamic banking and conventional banking might not necessarily be substitutes to each other. As in this case they seem to complement each other. Our findings are in line with Imam and Kpodar (2015). As far as economic volatility is concerned, we did not find any of the banking development indicator significant both in estimations 3 and 4. So in case of the OIC member country's banking credit be it conventional or Islamic does not impact economic volatility.

Regarding the control variables, inflation came out positive and significant in all the four estimations presented in Table 2.2, implying that inflation where on one side is significant for growth with positive coefficients, it is also positively significant toward economic volatility. On the other hand, trade openness seems to be not significant for the growth of the OIC economies. Whereas, trade openness has a positive and significant relationship with economic volatility.

Now let us discuss the estimations presented in Table 2.3, which show us the impact of deposit on economic growth and volatility. Columns 1 and 2 have LGDPG as dependent variable, whereas columns 3 and 4 have LSDGDPG as dependent variables. In column 1 we have LTDEPOSIT along with control variables as independent variables. Total deposit seems to be positively impacting the economic growth of the OIC member countries. This finding is in line with the results of Table 2.2. The coefficient is positive and significant at 5 % significance level. It shows that 1 % increase in the total deposit will increase GDP growth by 2.55 %. In the second specification where total credit was replaced with conventional (LCDEPOSIT) and Islamic deposit (LIDEPOSIT). We found that both conventional and Islamic banking have positive coefficients but only conventional banking deposit is significant to economic growth. Islamic banking deposit is found to be insignificant toward economic growth. These results are different from the estimations where we used credit as proxy of banking development. One possible reason is the smaller size of Islamic banking deposits in terms of GDP. It also suggests that Islamic banking and conventional banking might not necessarily be substitutes to each other while impacting economic growth. As far as economic volatility is concerned, in line with our previous results, we did not find any the banking development indicators significant both in specification 3 and specification 4. So in case of the OIC member countries banking deposits, be it conventional or Islamic, they do not impact economic volatility. As far as control variables are concerned, the impact of inflation and openness remain consistent even with different specifications. Inflation is found to be significant to both economic growth and volatility. On the other hand, trade openness seems to be not significant for the growth of the OIC economies, whereas, it seems to be increasing economic volatility.

7 Conclusion

The recent growth of the Islamic banking industry is in line with the demand of banking products based on Islamic principles. Although the literature on the impact of Islamic banking development on economic growth is increasing, its impact on the economic volatility has been ignored. In this chapter, we examine the impact of Islamic banking development on economic growth and volatility. To achieve our objective, we have used aggregate banking and macroeconomic data for 21 OIC member countries that have both Islamic and conventional banking prevailing in their financial system. Our annual panel dataset spans from 2007 to 2013. We have used GMM estimations for our study.

We find that, keeping other growth determinants constant, banking credit and deposit have positive impact on the economic growth of the OIC member countries. As far as Islamic banking is concerned, the impact of Islamic credit on the economic growth is positive, which implies that it is helping in meeting the needs of households and firms. Our finding is promising, as though Islamic finance is rapidly growing, it still represents a small share of the economy and also of the total size of the financial system and it has also not attained the level where it can achieve the benefits of economies of scale. Conventional deposit and credit has also shown positive impact on economic growth. As far as economic stability is concerned, both Islamic and conventional banking credit and deposits are found to be insignificant. Our analysis also shows that Islamic banking complements conventional banking in the OIC member countries.

As Hasan and Dridi (2011) stated in their paper, Islamic finance does not only help to increase growth, but it also seems to be less prone to risks, such as bubbles, which implies that the Muslim countries majority of which are suffering from low growth might try to develop Islamic finance further in their economies. For which, it is necessary to bring proper legislation in place and develop supporting infrastructure, including promotion of necessary set of skills required for Islamic finance at an early stage. Our study suggests future research to include better measure of the magnitude of the growth effect of Islamic banking and also assess the impact of Islamic banking on macroeconomic efficiency.

Appendix

Table 2.A List of countries with conventional and Islamic banks

S. No.	*Country*	*Conventional banks*	*Islamic banks*
1	Bahrain	12	20
2	Bangladesh	38	8
3	Brunei Darussalam	1	1
4	Egypt	23	3
5	Indonesia	75	10
6	Iraq	13	7
7	Jordan	10	3
8	Kuwait	6	11
9	Lebanon	49	3
10	Malaysia	34	18
11	Mauritania	9	2
12	Pakistan	22	9
13	Palestine, State of	2	2
14	Qatar	6	6
15	Saudi Arabia	8	5
16	Senegal	11	1
17	Sudan	9	16
18	Tunisia	18	1
19	Turkey	33	5
20	United Arab Emirates	19	9
21	Yemen	5	4
		403	144

Notes

1. Can be extracted from: http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf
2. Can be extracted from: http://www.ifsb.org/standard/ifsb2.pdf
3. Please refer to the Appendix for the list of countries along with number of banks from each country (see Table (2.A)).

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CHAPTER 3

Role of Islamic Banking in Financial Inclusion: Prospects and Performance

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Abstract According to Global Financial Development Report 2014, the proportion of adult population holding bank accounts in 25 out of 48 Organization of Islamic Cooperation (OIC) member countries surveyed stands below 20 %. Part of the reason is Muslims' voluntary exclusion of interest-based financial services. On average, 28 % adults in the OIC countries hold a bank account at a formal financial institution. On the other hand, only 7.7 % of the poorest 40 % people in the OIC countries borrow from financial institutions. Furthermore, in the OIC countries, like Guinea-Bissau, Gabon, Chad, Sudan, Syria, Mozambique, Gambia, and Iraq, microfinance outreach are not even catering to the 1 % of the poor people in these countries. In 26 out of 36 OIC countries where sufficient data are available, we find that not even 10 % of the poor people are under the microfinance radar. Thus, this presents a challenge as

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well as an opportunity for Islamic banks to increase their outreach toward fostering inclusive finance in the OIC countries.

Keywords Islamic banking · Islamic finance · Financial inclusion · Microfinance

1 Introduction

The empirical literature largely supports a positive association between financial development and economic growth. In general, countries with more developed financial systems enjoy greater economic growth rates. North (1990) and Neal (1990) concluded from their study that regions that developed relatively more sophisticated and well-functioning financial systems were the ones that were the subsequent leaders in the economic development of their times. Odedokun (1998) also concludes that the growth of financial aggregates in real terms has positive impacts on economic growth of developing countries, irrespective of the level of economic development attained. Levine (2002) using cross-country data argues that financial development is robustly linked to economic growth. Even for the Organization of Islamic Cooperation (OIC) member countries, Hassan, Sanchez and Yu (2011) find a positive relationship between financial development and economic growth.

However, the issue in developing countries is that financial services are not accessible to the masses of poor people. Voluntary exclusion due to faith reasons creates yet another hindrance in the way of financial inclusion in the OIC countries. According to World Values Survey sixth wave (2010–2014), 75.4 % respondents in 21 OIC member countries regard religion as "very important" as compared to 36 % holding the same view in the non-OIC countries. According to Islamic scholars, modern day interest is Riba, which is prohibited in Islam (Verse 275: Al-Baqarah). Therefore, voluntary exclusion from interest-based banking products and services in Muslim societies could be significant. A survey of 65,000 adults from 64 economies reveals that Muslims are significantly less likely than non-Muslims to own a formal account or save at a formal interest-based financial institution after controlling for other individual and country-level characteristics (Demirgüç-Kunt et al.

2013). For instance, in countries, like Afghanistan, Morocco, Iraq, Niger, and Djibouti, the percentage of adult population with no bank accounts for religious reasons stands at 33.6 %, 26.8 %, 25.6 %, 23.6 %, and 22.8 %, respectively (Naceur et al. 2015). Thus, Muslims, in particular, need financial solutions that are Shari'ah compliant. To cater to this need, Islamic banking institutions were established in various parts of the world.

Globally, Islamic banking first appeared as social finance in the 1960s. Mit Ghamr Islamic Savings Bank was started in Egypt by El-Naggar in 1963. Around the same time, the Pilgrims

Fund Corporation or Tabung Haji started operations in Malaysia in 1963 to enable Muslims to save for meeting expenses of the Hajj pilgrimage (Chachi 2005).

However, modern incorporated Islamic commercial banking began in 1979 with the establishment of Dubai Islamic bank. Since then, the Islamic financial institutions have been established in many OIC regions, including the Middle East, South Asia, East Asia, and Northern Africa.

Global Islamic banking assets exceeded $925 billion in 2015. Among individual countries, market share of Islamic banking in national banking remains at 51.2 % in Saudi Arabia, 45.2 % in Kuwait, 29.3 % in Bahrain, 25.8 % in Qatar, 21.6 % in the United Arab Emirates (UAE), 21.3 % in Malaysia, and 10.4 % in Pakistan. In the aftermath of the financial crisis of 2007–2009, Islamic banking has maintained higher Compound Annual Growth Rate (CAGR) than conventional banks in all countries except the UAE. In countries like Indonesia, Pakistan, Turkey, Qatar, and Saudi Arabia, the CAGR have exceeded 20 %. Table 3.1 gives a growth comparison in Islamic and conventional banking in selected countries.

In this chapter, we explore the strategic positioning of Islamic banking on ideological and economic grounds. In Sect. 2, we discuss the role of Islamic banking as seen by the idealists and the realists. Despite the lack of consensus on the idealistic and realistic schools of thought on the strategic direction and positioning of Islamic banking, we argue that it has an extremely important role to play in dealing with financial exclusion in Muslim majority countries. In Sect. 3, we look at the state of financial inclusion in the OIC countries. In Sect. 4, we estimate the microfinance outreach gap in the OIC countries. Finally, in Sect. 5, we discuss how

Table 3.1 Growth comparison in Islamic and conventional banking

Compound annual growth rate (2010–2014) (%)		
Country	*Islamic banking*	*Conventional*
Indonesia	29	11
Pakistan	27	13
Turkey	25	16
Qatar	22	7
Saudi Arabia	20	7
Malaysia	17	9
The UAE	13	19
Kuwait	10	4
Bahrain	4	–1

Source: E&Y Islamic Banking Competitiveness Report 2015–2016

Islamic banks can contribute in enhancing the coverage of inclusive finance in the OIC countries.

2 Islamic Banks as Intermediaries: Idealism Versus Realism

Islamic banks use Shari'ah compliant contract structures to design and offer financial products. However, they work as commercial financial intermediaries. Pioneer scholars envisioned Islamic banks to be not only Shari'ah compliant, but also distinctively contributing toward the achievement of equitable income distribution, enhancing social mobility, achieving broad based financial inclusion, and fostering need fulfillment. However, the demands of the industry hamper in achieving these ideals on priority basis. This has created a wedge between the realists and the idealists. The realists are the executioners of Islamic banking on the ground and who have to compete alongside conventional banking within same legal, governance, and market conditions. Hence, they are obliged to pursue an evolutionary assimilation of Islamic banking to penetrate from ground zero into the mainstream and the dominant conventional banking system. The products though Shari'ah compliant are structured to compete with mainstream conventional banking industry. The idealists want a more revolutionary assimilation of Islamic

banking to create a distinctive mark on financial landscape right from the beginning. In what follows, we give a brief sketch of how the idealists and the realists have assessed the performance of Islamic banking practice so far.

Akram and Furqani (2013) explicate three specific ends (Maqasid) in Islamic finance, namely wealth circulation, fair and transparent financial practices, and justice at the micro- and macro-level. They argue that fulfilling minimal Shari'ah legal compliance in product structuring is insufficient to make progress toward these specific ends.

In defense, Khir (2013) explains that mainstream Muslim scholars supporting the Islamic finance movement contend that Islam recognizes the legitimacy of the time value of money in Islamic financial transactions such as deferred sale and bilateral rebate. Khan (2014) thinks that critics of Islamic banking do not appreciate how important debt financing is for value creation in an economy and especially for inclusive growth and economic development through making financial services accessible for asset acquisition. Chapra (2007) argues that even if debt financing is predominantly used in Islamic banking practice, asset backed financing does not allow the debt to exceed the growth of the real economy. He argues that the introduction of such a discipline would ensure greater stability as well as efficiency and equity in the financial system.

On the other hand, Islamic economists holding on to the more egalitarian vision like Siddiqi (2014) argue that the role of debts needs to be drastically reduced and replaced by participatory modes of finance. However, revealing the ground reality, Kayed (2012) observes that the experiences of Islamic banking in various Muslim countries have shown that the profit and loss sharing (PLS) model has been marginalized. Hassan and Bashir (2003) explain that Islamic banks' loan portfolio is heavily biased toward short-term trade financing. Islamic economists like Siddiqui (2007) who expect a lot from Islamic banks than just acting as financial brokers like conventional banks think that unless Islamic banking gradually moves away from debt like financing, it cannot claim to be a substantive alternative of the conventional banking system.

On the practical difficulties of moving toward PLS modes, Khan (1989) notes that informational asymmetry and higher monitoring costs hinder the widespread use of equity contracts. Khan and Bhatti (2006) explain that

banks do not find it feasible to enter into the PLS relationship with business people whose majority maintains double sets of accounts for the sake of avoiding exorbitant tax payments. The absence of a just and speedy judicial system also discourages banks from adopting the PLS system. Business people also show high reluctance to enter into the PLS relationship in order to preserve privacy of their business operations from outside stakeholders.

Other critics of Islamic banking dismiss the notion that the current models and institutional structure can result in any real and meaningful transformation of the way banks function. Choudhury (2012) unequivocally remarks that Islamic banking is a mainstream enterprise, good for the rich shareholders in the narrow preconceived notion of avoidance of financial interest, while not understanding the epistemological meaning underlying this principle. Haniffa and Hudaib (2010) argue that Maqasid al-Shari'ah (purposes of the law) has been unduly used to justify the innovation of financial products to compete and converge with conventional banking. Another staunch critic of Islamic finance practice, El-Gamal (2005) observes that Islamic finance as it exists today is a prohibition-driven industry, which attempts to provide Muslims with permissible analogs of conventional financial services and products that are generally deemed impermissible in Islamic jurisprudence. El Gamal (2007) in another study contends that growth in Islamic finance over the past three decades has been led by rent-seeking Shari'ah arbitrageurs, whose efforts continue to be focused on synthesizing contemporary financial products and services for classical nominate contracts, without regard to the corporate structure of financial institutions.

Thus, we find that there is a drift in the idealist and realist camps. But, given the low levels of financial inclusion and outreach of financial services to the lower segments, Islamic banks have an important role to play. If they are able to contribute in these dimensions, it can hopefully lead to reduce apprehensions and drift in the idealist–realist camps. In the next two sections, we highlight the important gaps that exist for Islamic banking to fill in the area of financial inclusion and outreach in Muslim majority countries.

3 State of Financial Inclusion in the OIC Countries

In this section, we explore the state of financial inclusion in the OIC countries. We look at the proportion of adult population holding bank accounts and borrowing from banks. We also look at how easy it is to come up with emergency funds in the OIC countries for the poorer and richer

Table 3.2 Bank account penetration in the OIC countries

Account at a formal financial institution (% age 15+)			
Country Name	*2014*	*Country Name*	*2014*
Iran	92	Tunisia	27
The United Arab Emirates	84	Jordan	25
Bahrain	82	Mauritania	23
Malaysia	81	Mali	20
Kuwait	73	Kyrgyz Republic	18
Saudi Arabia	69	Togo	18
Turkey	57	Benin	17
Kazakhstan	54	Sierra Leone	16
Bosnia	53	Senegal	15
Algeria	50	Sudan	15
Kosovo	48	Burkina Faso	14
Lebanon	47	Egypt	14
Nigeria	44	Pakistan	13
Uganda	44	Cameroon	12
Uzbekistan	41	Chad	12
Albania	38	Iraq	11
Indonesia	36	Tajikistan	11
Côte d'Ivoire	34	Afghanistan	10
Gabon	33	Guinea	7
Bangladesh	31	Niger	7
Azerbaijan	29	Yemen	6
		Turkmenistan	2

Source: Global Financial Development Report 2014

segments of the society. We use the data from the World Bank survey on financial inclusion as well as Global Financial Development Report 2014.

Table 3.2 shows the percentage working age population holding bank account at a formal financial institution as a proportion of total population. On average, 28 % adults in the OIC countries hold a bank account at a formal financial institution. This is lower than the 30.26 % average for the middle-income countries and 93.05 % average for the high-income countries. The OIC countries with higher per capita incomes have half of their adults holding a bank account. These include countries like Kuwait, Iran, Oman, Malaysia, Qatar, Bahrain, the UAE, and Turkey. The OIC countries with less than 10 % adults holding bank accounts mostly include members from Africa. Countries like Egypt, Chad, Sudan, Senegal, Guinea, and Niger have lower than 10 % adults with bank accounts at a formal financial institution.

Table 3.3 Bank borrowers as proportion of adult population

Bank borrowers (per 1,000 adults)					
Country Name	*2013*	*Percent*	*Country Name*	*2013*	*Percent*
Turkey	865.60	86.56	Bangladesh	84.12	8.41
Brunei Darussalam	627.31	62.73	Mozambique	60.65	6.07
Suriname	466.73	46.67	Djibouti	51.22	5.12
Malaysia	403.35	40.33	Uzbekistan	47.73	4.77
Indonesia	377.16	37.72	Syrian Arab Republic	44.05	4.40
Lebanon	298.91	29.89	Algeria	43.73	4.37
Bosnia	282.37	28.24	Kyrgyz Republic	42.94	4.29
Qatar	249.23	24.92	Mauritania	36.31	3.63
Azerbaijan	239.24	23.92	Tajikistan	35.22	3.52
Tunisia	203.98	20.40	Nigeria	26.96	2.70
Saudi Arabia	184.36	18.44	Pakistan	24.55	2.45
Kuwait	167.71	16.77	Uganda	18.50	1.85
Libya	141.22	14.12	Sierra Leone	15.71	1.57
Maldives	138.23	13.82	Guinea	10.33	1.03
Egypt	113.23	11.32	Afghanistan	4.12	0.41
Gabon	110.91	11.09	Chad	3.71	0.37

Source: World Development Indicators, World Bank

Table 3.3 shows the number of bank borrowers per 1,000 adults. We see that only in Turkey and Brunei more than half of the adults are bank borrowers.

In countries like Nigeria, Pakistan, Uganda, Sierra Leone, Guinea, Afghanistan, and Chad, less than 30 persons per 1,000 adults obtain loans from banks. In almost half of the countries under observation (16 out of 33), less than 10 % adults are bank borrowers. It could be said that low bank borrowing could be voluntary rather than involuntary. However, we observe that the income poverty rate is less than 30 % only in 3 countries out of 16 countries where bank borrowing adult population is less than 10 % of total adult population. Thus, much of the OIC member states with less bank borrowing population are largely poor and hence, they may face binding liquidity constraints due to involuntary financial exclusion.

Hence, we see that the OIC countries have low levels of financial inclusion. Islamic banking has a challenge as well as an opportunity to offer inclusive financial services to the voluntary and involuntary excluded population. So far, Islamic banking products offer Shari'ah compliance,

but their credit criteria in debt-based products include and exclude similar kinds of clients. Thus, they remain an alternative means of doing banking for those people who voluntarily excluded themselves from conventional finance even though they are "bankable" clients for both conventional and Islamic banks.

Developed and emerging Muslim majority countries in East Asia like Malaysia along with Turkey in Europe and Kuwait, Bahrain, Qatar, and the UAE in the Middle East have been relatively more successful in improving financial inclusion. The hard miles in the journey come in developing countries where the individual savings are not enough and big corporate businesses do not exist due to a host of lag in institutional and infrastructural development. In the next section, we explore whether the microfinance fills the gap left by the absence of commercial banks in the OIC countries, especially in the poorer ones.

4 Microfinance Outreach Gap in the OIC Countries

As discussed earlier, Muslim countries represent a quarter of the global population, but they are generally poorer than non-Muslims as their share in the global poverty pool is twice as much as their share in global population. Table 3.4 shows the incidence of poverty as measured by the poverty headcount ratio. The poverty measure is computed based on each country's national poverty line. We also present the total number of microfinance borrowers in each of the respective OIC countries. Then, we also provide the outreach gap measured as the difference between the estimated number of total poor people in the country and the total number of microfinance borrowers. Last column also shows the outreach gap as a percent of the total poor population in the country. We take data on the microfinance footprint in the OIC countries from MIXMARKET.

In the OIC countries, like Guinea-Bissau, Gabon, Chad, Sudan, Syria, Mozambique, Gambia and Iraq, microfinance outreach are not even catering to 1 % of the poor people in these countries. In 26 out of 36 countries where sufficient data are available, we find that not even 10 % of the poor people are under the microfinance radar. In five OIC countries, the poverty headcount ratio at national poverty line exceeds half of the population. In these OIC countries where the poverty headcount ratio is more than 50 %, not even 10 % of the poor people is reached by microfinance.

Table 3.4 Microfinance outreach gap in the OIC countries

Country Name	*PHCR-National (%)*	*Total Borrowers*	*Total Population*	*Total Poor*	*Outreach Gap (no.)*	*Outreach Gap (%)*
Guinea-Bissau	69.3	1,662	1,663,558	1,152,846	1,151,184	99.9
Togo	58.7	297,093	6,642,928	3,899,399	3,602,306	92.4
Guinea	55.2	117,037	11,451,273	6,321,103	6,204,066	98.1
Mozambique	54.7	68,299	25,203,395	13,786,257	13,717,958	99.5
Sierra Leone	52.9	110,713	5,978,727	3,162,747	3,052,034	96.5
Niger	48.9	218,109	17,157,042	8,389,794	8,171,685	97.4
Gambia, The	48.4	4,389	1,791,225	866,953	862,564	99.5
Burkina Faso	46.7	201,537	16,460,141	7,686,886	7,485,349	97.4
Senegal	46.7	282,745	13,726,021	6,410,052	6,127,307	95.6
Chad	46.7	21,430	12,448,175	5,813,298	5,791,868	99.6
Sudan	46.5	67,435	37,195,349	17,295,837	17,228,402	99.6
Nigeria	46.0	2,600,000	168,833,776	77,663,537	75,063,537	96.7
Mali	43.6	271,619	14,853,572	6,476,157	6,204,538	95.8
Cameroon	39.9	292,146	21,699,631	8,658,153	8,366,007	96.6
Benin	36.2	305,470	10,050,702	3,638,354	3,332,884	91.6
Afghanistan	35.8	148,033	29,824,536	10,677,184	10,529,151	98.6
Syrian Arab Republic	35.2	32,518	22,399,254	7,884,537	7,852,019	99.6
Yemen, Rep.	34.8	112,494	23,852,409	8,300,638	8,188,144	98.6
Gabon	32.7	907	1,632,572	533,851	532,944	99.8
Tajikistan	32.0	339,039	8,008,990	2,562,877	2,223,838	86.8
Bangladesh	31.5	18,600,000	154,695,368	48,729,041	30,129,041	61.8

Table 3.4 (continued)

Country Name	*PHCR-National (%)*	*Total Borrowers*	*Total Population*	*Total Poor*	*Outreach Gap (no.)*	*Outreach Gap (%)*
Kyrgyz Republic	30.6	432,980	5,607,200	1,715,803	1,282,823	74.8
Lebanon	28.6	79,017	4,424,888	1,265,518	1,186,501	93.8
Egypt, Arab Rep.	25.2	905,888	80,721,874	20,341,912	19,436,024	95.5
Pakistan	22.3	3,600,000	179,160,111	39,952,705	36,352,705	91.0
Uganda	19.5	731,393	36,345,860	7,087,443	6,356,050	89.7
Iraq	18.9	56,008	32,578,209	6,157,282	6,101,274	99.1
Bosnia and Herzegovina	17.9	257,037	3,833,916	686,271	429,234	62.5
Uzbekistan	16.0	176,029	29,774,500	4,763,920	4,587,891	96.3
Tunisia	15.5	263,268	10,777,500	1,670,513	1,407,245	84.2
Jordan	14.4	333,723	6,318,000	909,792	576,069	63.3
Albania	14.3	63,280	2,900,489	414,770	351,490	84.7
Indonesia	11.3	1,200,000	246,864,191	27,895,654	26,695,654	95.7
Morocco	8.9	883,852	32,521,143	2,894,382	2,010,530	69.5
Kazakhstan	2.9	241,976	16,791,425	486,951	244,975	50.3
Turkey	2.3	67,414	73,997,128	1,701,934	1,634,520	96.0

Most poor people are in Nigeria, followed by Bangladesh, Pakistan, Indonesia, and Egypt. In all these eight OIC member states, the poor population exceeds 20 million in numbers. Bangladesh has the highest outreach in microfinance. Along with Bangladesh, Pakistan, Nigeria, and Indonesia are the other OIC countries where microfinance client base exceeds 1 million. Nevertheless, apart from Bangladesh, the outreach gap is more than 90 % in Pakistan, Nigeria, and Indonesia.

Islamic microfinance is an alternative for people who wish to obtain relief in their income and liquidity constraints to smooth consumption of their own and their family members. Obaidullah (2008) explains that there are two broad categories of Islamic microfinance models that are globally used, i.e. charity based not-for-profit models and market-based commercial models. The former model uses Qard-e-Hasan, Waqf, and Zakat funds for providing non-compensatory loans or non-repayable grants. Market-based commercial models provide microcredit using Murabaha and micro-leasing using Ijarah.

The theoretical edge of Islamic microfinance has been studied by several Muslim economists. According to Ahmed (2002), Islamic Microfinance Institutions (IMFIs) appear to have performed better than Grameen Bank. Ahmed (2002) expects IMFIs to benefit from the social capital derived from Islamic values and principles. Ahmed (2002) reasons that IMFIs can reduce high monitoring costs substantially since Islamic modes of financing involve a real transaction. The moral hazard problem arising from the use of funds for purposes other than those intended substantially reduces in Islamic contracts. Komi and Croson (2013) find significantly higher compliance rates for the Islamic-compliant contracts (profit-sharing and joint venture) than for the traditional contract (interest based). Ashraf, Hassan and Hippler III, W. (2014) in an empirical study provide evidence that low religious orientation corresponds to higher levels of risk and default. Citing another ethical benefit of Islamic microfinance due to its risk sharing and asset backed nature, Samad (2014) argues that if Islamic microfinance is offered in India, the mass suicides committed especially by the Indian farmers can be contained to a great extent and can be virtually stopped.

However, in terms of realizing the theoretical and structural potential, we do not find an impressive progress. Islamic microfinance is still just 1 % of the total global Islamic banking assets. This is despite the impressive growth and stable profits of the Islamic commercial banks all over the world. Awareness about Islamic banking is cited as one important hindrance in Islamic banking practice; however, with wide geographical

penetration and targeted products for the lower segments of society, the awareness issue can be tackled more directly as well as provide an opportunity for the average Muslims to benefit from Islamic banking and finance on a wide scale.

5 How Could Islamic Banking Contribute in Financial Inclusion

In this section, we discuss how Islamic banking can contribute in enhancing the coverage of inclusive finance in the OIC countries by leveraging on technology, using equity-based modes of finance and focusing attention toward microfinance.

5.1 Use of Information and Communications Technology (ICT)

In the Global Financial Development Report 2014, one-fifth of the unbanked respondents cited distance as a major barrier. Using the Information and Computer Technology (ICT), Islamic banks can help in increasing financial inclusion in locations where physical presence is costly. Nowadays, the urban banking population also requires convenient banking solutions. According to World Islamic Banking Competitiveness Report (Nazim and Kasbati 2016), mobile banking usage in the UAE stands at 34 %, followed by 27 % in Kuwait, 19 % in Qatar, and 15 % in Saudi Arabia. In GCC, 26 % Islamic banking customers use mobile banking as compared to 38 % customers in conventional banking. Thus, the use of ICT can also help in economizing on physical infrastructure to reach lower segments of the society in rural areas and conveniently engaging with and retaining customers in the urban areas.

5.2 Increased use of Equity-based Modes of Financing

The equity-based modes of financing are ideally suited where the clients lack collateral and require entrepreneurial capital as well as income support. Islamic banks have largely avoided using equity-based modes of financing in commercial asset side operations due to high monitoring and agency costs. Islamic banks can use their surplus liquidity to introduce equity-based modes of financing for the lower income segments of the society.

Using equity-based modes of financing for financing microenterprises that employ poor workers can be useful if individual level financing has high agency and transaction costs. Organizing labor-intensive businesses as microenterprise can yield technical and financial economies of scale. Labor-intensive businesses such as furniture making, house maintenance, catering, home textile, light engineering and dairy, fish, poultry, and fish farming can be organized as microenterprise and the Islamic banks can use equity-based modes of financing to finance these microenterprises.

5.3 Increased Focus Toward Microfinance

According to Global Financial Development Report 2014, about 80 % of the poor living under 2 dollars a day have no bank accounts. Since the majority of rural poor are voluntarily as well as involuntarily financially excluded, they require finance for achieving higher social mobility and for ensuring survival. Most poor people do not own many valuable fixed assets. Hence, they are unable to furnish collateral and hence remain underserved by the commercial banks. Even the assets they own like land, livestock, or furniture are not admissible as collateral by commercial banks. Islamic microfinance institutions providing asset backed financing have an inbuilt cushion in the sense that all their financing activities are backed by a real asset.

Thus, Islamic microfinance is vital for enhancing financial inclusion of lower income segments. Islamic microfinance can be used to extend funding for the purchase of small business assets, appliances, tools, food processing machines, and tradable inventory. Islamic micro insurance products can also help in income smoothing of poor farmers who otherwise have to sell their small productive capital that further puts them at poverty risk.

6 Conclusion

In this chapter, we explored the state of financial inclusion in the OIC countries. We noted that the proportion of adult population holding bank accounts in 25 out of 48 OIC countries stands below 20 %. We also estimated the microfinance outreach gap in the OIC countries to focus attention toward the extent of involuntary financial exclusion in the OIC countries. According to our estimates, we find that not even 10 % of the

poor people are under the microfinance radar in 26 out of 36 OIC countries where sufficient data are available. To reduce financial exclusion, we recommend that Islamic financial institutions leverage on technology, use equity-based modes of finance, and focus attention toward microfinance.

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CHAPTER 4

Marketing Effectiveness of Islamic and Conventional Banks: Evidence from Malaysia

Baharom Abdul Hamid, Syed Najibullah, and Muzafar Shah Habibullah

Abstract The study aims to address marketing effectiveness of both Islamic banks and conventional banks (CBs) by using a modified "chain-of-effect" framework. Against current literature, which is based on customer surveys, reports do not include marketing activities by the Islamic banks (IB); this study adopts a bank perspective to explore the IB's behavior in this regard. Applying fixed-effect panel regression on the quarterly data of five IBs and five CBs in Malaysia, the study aims to explore the influence of marketing efforts on performance (both financial and nonfinancial) and if such relation varies by the type of banks in Malaysia. The findings of the study show that IBs are performing well in using marketing efforts to generate meaningful financial and nonfinancial performance.

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Keywords Marketing effectiveness · Performance · Market share · Carry-over effect · Islamic banking

1 Introduction

Does "religious affinity" create any competitive advantage for the Islamic banks (IBs) over conventional counterparts?

The emergence of IB certainly has changed the rules of the business by creating two different markets—Islamic and conventional—as Muslims are not supposed to use CBs where IB services are available (Ariss 2010; Mirakhor and Bao 2013).

The purpose of marketing efforts, especially of advertising and other promotional activities, is to attract consumers. That is why we often encounter firms engaged in marketing wars to strengthen their visibility and presence in the market. When we talk about IB, we expect that consumers, especially Muslims, will favor IB over all other available lucrative options offered by their conventional counterparts. In that case, IBs are generally expected to expend less effort in marketing compared to the CBs, as "religious affinity" is supposed to give them the desired competitive edge. This lack of marketing efforts by IBs has been frequently reported in the literature (Ahmad and Haron 2002; Dusuki and Abdullah 2007; Khan et al. 2008; Haque et al. 2010; Bin et al. 2011; Hakim et al. 2011; Thambiah et al. 2011; Abdullah et al. 2012).

In fact, the emergence of IBs is threatening to CBs as they may lose their market share to them. In most cases, the CBs responded quite proactively by opening window banking and separate subsidiaries, to handle such changes in the external environment, especially in Muslim majority countries. And such a counter-strategic move proved to be successful, especially in Malaysia, where the top-performing IBs are mostly the subsidiary of business groups that have been in the conventional banking business for a long time.[1]

Given that there is too much focus on the product, and performance analysis of the literature, the issues related to marketing and strategic management of the IBs go unnoticed to a greater extent. Although Musaeva, Mohamad and Shah (2014) reported the exorbitant presence of marketing-related studies in the literature, especially on patronage factors, those studies were more survey-based (customer surveys) and thus overlooked the banks' perspective. This study, therefore, makes an

attempt to explore how effectively banks are managing their marketing activities to improve their performance and if it does vary by the type of banks (IB and CB).

The earlier studies addressed such dilemmas by approaching customer surveys and reported quite similar findings. Haron, Ahmad and Planisek (1994) reported the absence of any significant differences between Muslim and non-Muslim factions in bank selection criteria. The study reported that only 40 % of the Muslim customers preferred IBs for religious belief. Similar findings were reported by Hamid and Nordin (2001). Ahmad and Haron (2002) pointed out inadequate marketing efforts by the IBs, while analyzing the sentiments of the corporate customer segments and their knowledge of Islamic banking products. It is often found that the consumers change their purchasing behavior in response to marketing activities, which was not well reflected in the survey (Pauwels et al. 2014).

This study, nevertheless, attempts to fill this gap and looks at the issue at hand from the banks' perspective to see how much marketing effort the banks expend to improve their business and if this differs by the type of bank either IB or CB. Therefore, the research questions that the study intends to address are as follows:

- How does marketing effort affect the performance of both IBs and CBs?
- Is the extent of marketing effectiveness same for both IBs and CBs?

The findings of the study are expected to provide an assessment of the marketing performance of the banks and help bank management to develop marketing metrics to keep track of the marketing performance and aid budgetary allocation decisions. The study will also help bank management identify how their decisions on marketing activities might contribute to the bank's bottom line in both short and long term.

The study is envisaged to encourage the managers to use marketing as a means to create opportunities for achieving a long-term competitive advantage.

2 Literature Review

"half of my advertising is wasted; I just do not know which half" (Wannamaker 1920). The words of John Wanamaker in 1920s seem to prevail today also when Ries and Trout (1982) in a similar tone states,

"More money is wasted in marketing than in any other human activity" (Pauwels et al. 2014). Although marketing seems to be a very ambiguous field of study, the competitive environment of modern day business appears to necessitate the successful implementation of marketing, if a firm is to advance in its chosen market segments. IBs are no exception.

Marketing is regarded as the pivotal force behind strategic planning and business operations, and, hence, as an intrinsic component of organizational efforts (Kwaku and Alan 2001). In marketing literature, authors have extensively used the resource-based view (RBV) framework to examine firm performance, to explore the interrelation between marketing and other functional capabilities and their interweaving effect on performance (Nath et al. 2010). The findings reported a significant positive relationship between a firm's capabilities and performance. RBV argues that the type and nature of resources and level of capabilities will vary across firms. However, the success depends upon the firm's ability to generate new resources, strengthen its capabilities, and create a synergy between these two to form an inimitable competitive advantage. Therefore, possessing superior resources might not guarantee success; rather exploiting the available resources and capabilities in a planned way to bring "immobility and inimitability" in the mix of firm's resource-capability framework will help the firm attain its objective (Fig. 4.1).

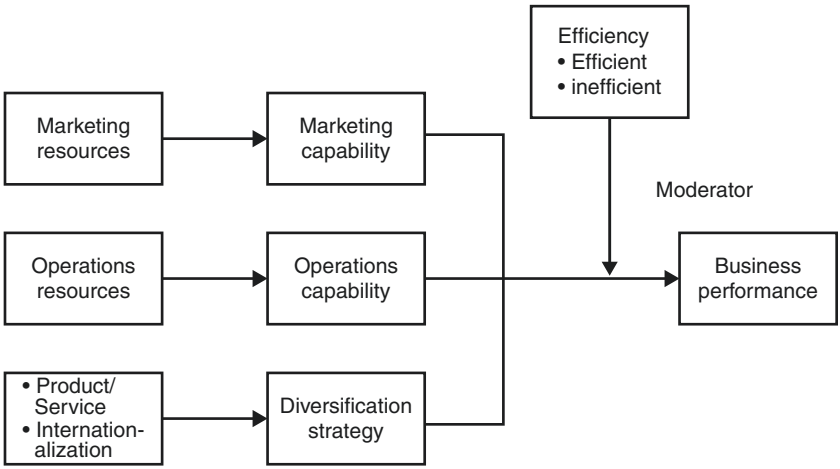

Fig. 4.1 RBV to measure resources–capabilities–performances transformation

The above framework places marketing capability in a meaningful context and shows how a firm exploits its critical capabilities in marketing and operations; and pursues a diversification strategy to achieve competitive advantage. Such a framework bodes well for our study highlighting the relevance of the study in exploring the relationship between marketing effectiveness and banks' performance.

Marketing expenditures have always been at the forefront of cost control and management (Baidya and Basu 2008), challenging it to prove its worth. Measuring marketing effectiveness, therefore, has become one of the major research areas for academicians. One of the ways to justify the presence of marketing expenditures is to justify ends with means, that is, to show quantitatively that the marketing efforts are generating the intended impact both in terms of customers' behavior and financial outcome (Ambler 2000; Barwise and Farley 2004; Bruhn et al. 2009). In fact, Hanssens (1996) in his address to CEOs, advocated for investment in maintaining customers' profile so that marketing effectiveness can be evaluated against performance and budgetary allocation can be followed through effectively.

In the literature on marketing, the process of justifying marketing performance has been discussed from four theoretical perspectives—control theory, institutional theory, orientation theory, and agency theory.

Ambler, Kokkinaki and Puntoni (2002a) provided a comprehensive summary of this theoretical discussion. As summarized by the authors, control theory emphasizes on comparing management's planned strategic goals with actual performance and, therefore, highlights the minimization of variance. Hence, performance measures have to be in place for marketing efforts to facilitate such a comparison. Institutional theory, on the other hand, dictates that firms' behavior are influenced by both the internal (culture, values, and norms), and the external (competitive environment, regulations, society, technology, etc.) environment. Meanwhile, orientation theory posits that the choice of performance measures will be guided by the top management's perception of its business. For instance, market-oriented performance measures suit a market-oriented business well. Agency theory focuses on checks and balances between two levels of management and in the process specific performance measures help the interaction between these two levels. In the end, the authors conclude, "These four theories overlap, but one conclusion is that metrics are important not just for the information they contain, but for their portrayal of what top management considers important."

In a careful note, Ambler et al. (2002b), however, highlighted the needs of having both internal (to compare management's expectation and actual performance) and external (accounting market factors, competitiveness, etc.) benchmarks to assess marketing performance validly (Ambler et al. 2002a). Assmus, Farley, and Lehmann (1984) further noted the importance of considering the carry-over effect of marketing efforts in the current year's performance as the effect of marketing to a greater extent takes longer period to decay, that is, firms benefit from current marketing efforts in the future (Ambler et al. 2002a). Lambin (1969) was of the similar opinion concerning the lagged effect of marketing.

Putting "marketing" in the strategic domain and its subsequent link to performance measurement and onward evaluation by the Board of Directors, Ambler (2000) proposed a two-tier performance metrics system which included both external and internal market metrics. While the internal market metrics were intended to assess the innovation health (promoting the culture of innovation practices inside the firm and its active consideration in the firm's strategic domain) and employee's engagement and commitment toward that, the external market metrics covered both financial and nonfinancial measures. According to the author, conventional profit and loss account metrics (financial measures), namely sales (both value and volume), marketing investment (the expenditures in fact), and bottom line (profit/loss) provide a shortcut approximation of the marketing performance. However, all these short-term measures are susceptible to the changes in brand equity, which includes, among others, "market share" as a nonfinancial measure. Clark (1999) also provides a detailed historical account of the convergence between financial and nonfinancial measures of marketing performance.

Rust et al. (2004) in their study offered a "chain-of-effect" model to illustrate how marketing efforts contribute to the shareholder value creation (Fig. 4.2). According to the authors, in order to establish the fact that marketing has a carry-over effect in the long run, that is, marketing is an "investment," we have to at first ascertain the asset it builds and then create a link to how this asset influences the short-run performance of the firm and creates room for future performance in the long run. Therefore, instead of focusing on the firm's products/service offerings, pricing, customer relationships, etc., we should be more oriented toward marketing expenditures in different marketing activities like marketing communication, promotions, etc. and its subsequent impact on market performance. For this, the firms have to create a mechanism through which they can track their performance

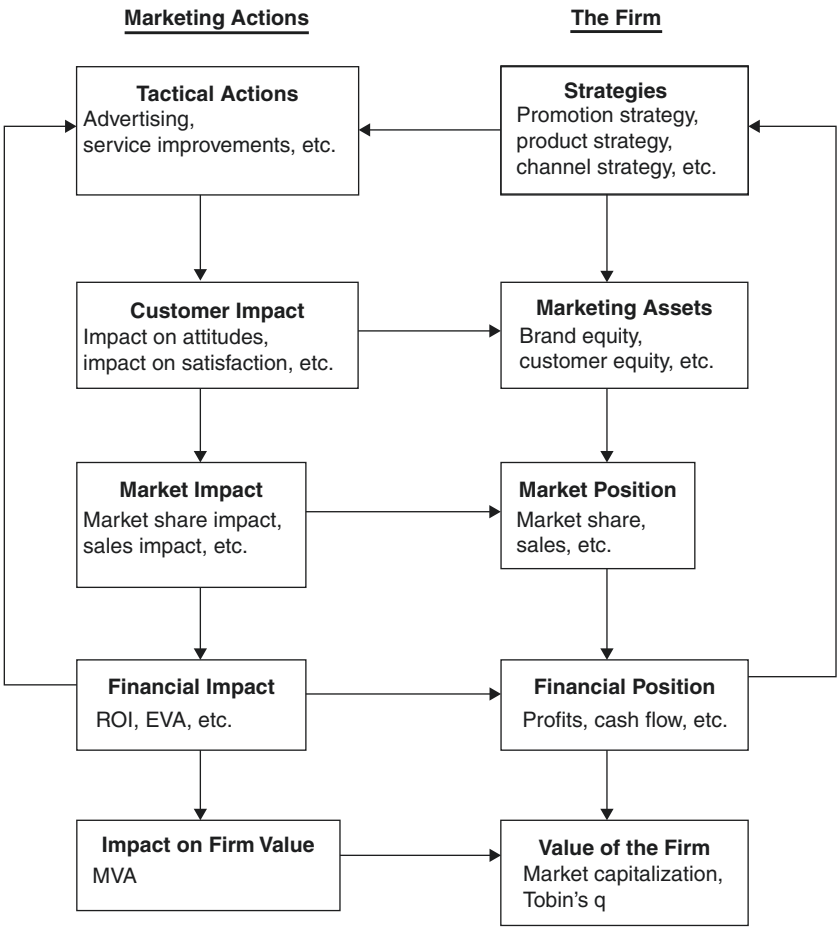

Fig. 4.2 The chain of marketing productivity

objectively, especially in terms of nonfinancial measures like customers' attitudes and behavioral intentions. These nonfinancial measures (also called the marketing assets), according to the authors, influence the financial measures like sales, profits, and shareholders' value in both short and long run. This line of thought, in fact, conforms to the findings of the study by Schoeffler, Buzzell and Heany (1974), who reported a significant positive

influence of market share over profitability. The study also showed that firms having a higher market share, but relatively inferior product quality, enjoy comparatively higher profitability as compared to the firms with a lower market share and relatively superior product quality. However, the authors also warned of a short-run penalty imposed upon the firms with inferior product quality of their competitors offering relatively superior ones. That, in fact, highlights the long-run effect of the market impact generated by marketing efforts on the firm's profitability.

Further, the study of McKee, Varadarajan and Pride (1989) demonstrated that the level of marketing effort is determined by the strategic orientation of the firms. Given the strategic orientation, marketing efforts dependent upon the market environment contribute to the firm's performance. Using the typology of organizational strategies (reactor, defender, analyzer, and prospector), the authors showed that market conditions, especially a volatile market, intervene in the firm's strategy–performance nexus and do not provide a clear direction. It shows, regardless of the firm's strategic superiority and organizational resource capability, the industry dynamics (size and growth) are also an influential explanatory variable. The authors also used firm's market share, return on asset (ROA), return on equity (ROE), to measure firm's performance, whereby market share, indicating operational performance, precedes the financial performance (ROA and ROE).

Moreover, a study, on marketing expenditures conducted by Barwise and Styler (2002) covering five industrialized countries, namely the USA, Japan, Germany, UK, and France, reported that 79 % of the firms report "market share" to the Board as the most practiced performance metrics, besides perceived product/service quality (77 %) being next in the row. Moreover, Baidya and Basu (2008), in a case study of evaluating the impact of marketing efforts (advertising, sales force, promotion, distribution, and price) on sales reported that all types of marketing efforts have significant positive impact on sales, except price.

A study on the US retail banking industry by Rhee and Mehra (2006) followed a more RBV as illustrated in Fig. 4.1, to show that competitive strategy moderates the relationship between operations and marketing strategic activities, and organizational performance, where organizational performance was measured through net interest income, fee income, ROA, and ROE.

From a strategic marketing perspective, marketing creates both short- and long-term effects. For an instance, advertising, in general, has both short and long run effects; whereas price promotions are more short-term

oriented and without short run effect, the long-run effect does not build up (Hanssens 2011). Dekimpe and Hanssens (1995) identified six major factors that help the marketing activities build long-run impact: instantaneous effects (immediate customers' response), carry-over effects (customers' delayed response), purchase reinforcement (repetitive purchase behavior), feedback effect (initial impact of marketing on sales leading to subsequent marketing decision), decision rules (the trade-off among the marketing tools based on performance of each), and competitive reactions (based on firm's objective of product or market expansion or stealing market share). Among these six factors, the first three factors reflect upon consumers' response and the last three highlight firms' strategic adjustment (Hanssens 2011).

Therefore, measuring marketing effectiveness is neither a single shot attempt nor a very straight forward exercise. It rather requires an understanding of interweaving relationships among many factors—firm's strategic choice, available resources and capabilities, marketing strategies and investment, market response and impact, industry environment, firm's effectiveness and efficiency, and lastly financial impact.

The issue of marketing, nevertheless, is also important from the perspective of *Shari'ah* Governance. The comprehensive *Shari'ah* Governance Framework promulgated by Bank Negara Malaysia specified the role of the *Shari'ah* Board in the bank's "product development process" that covers both pre- and post-product approval phases (BNM 2010). Moreover, marketing activities can also be seen as one of the important activities through which IBs can also explain their product offerings to the wider market, especially to non-Muslim segments and remove "gharar" (uncertainty), if there is any.

The emergence of Islamic banking in Malaysia can be traced back as early as in 1963 with the establishment of Tabung Haji or the Pilgrims Management and Fund Board by the government to bring the self-excluded Muslims in Malaysia into the formal banking channel. The success of Tabung Haji, later in 1983, encouraged the establishment of the first full-fledged IB in Malaysia, named Bank Islam Malaysia Berhad (BIMB). Subsequently, Islamic Windows started to gain popularity from March 1993 when the "Interest-Free Banking Scheme" (also known as Islamic banking scheme) was introduced by Bank Negara Malaysia (BNM), the Central Bank of the country. Afterwards, Bank Muamalat was established in 1999 to continue the momentum. With the financial market deregulation, foreign banks were also given the entry in 2004. After that, BNM opened the door to conventional banking groups so that

they could also offer full-fledged Islamic banking services through establishing Islamic banking subsidiaries.

Kamarulzaman and Madun (2013) reported a very limited presence of IBs in the electronic media, although the first IB has been in operation since 1983. To the contrary, the advertisement of Maybank Commercial Berhad is quite regularly aired on television.

Haron and Wan Azmi (2005), however, suggested that IBs in Malaysia ought not to market their products aggressively. Instead, the authors stressed that IBs should target the needs, preferences, and behavior of their target customers. According to the authors, religion *per se* is not the only critical factor that motivates the customers to use Islamic banking services. Moreover, the banks should also target non-Muslim customers. It might be true to the fact that Muslims do not enjoy an overwhelming majority in Malaysia, a pluralistic society having 38.7 % people following Buddhism, Christianity, Hinduism, etc. (Department of Statistics—Malaysia 2011). In addition to that, this Muslim majority might not be well represented in the national economy.

Therefore, targeting only the Muslims might not be an effective strategy for IBs, although religiosity might provide an initial boost to performance. In an attempt to study the effectiveness of the promotional tools, Bin Mahajar and Yunus (2011) reported that only sales promotion and publicity provided some impact in creating customer awareness regarding Islamic banking and the other marketing tools like direct marketing, advertising, and personal selling failed to create any such impact.

Moreover, Malaysia Islamic Finance Report (2015) included a "retail consumer financial services survey," which provides a more recent reflection on the customers' feedback and preference over the Islamic financial services.

A large percentage of non-Muslim customers have been reported to have banking relations with the IBs and on the contrary, a similar portion of the Muslim customers have also been reported to have accounts with CBs. They, having held CB accounts for more than ten years, seem to be satisfied with the current bank and showed less interest in IBs. Perhaps, they are not practicing Muslims and are very challenging for the IBs to convert. Moreover, the outreach of the IBs might be another issue.

As found in the survey, the CBs' immediate decision to venture into Islamic banking stream proved to be successful as it shows that the

consumers trust in Islamic banking solutions provided by CBs. It will no doubt encourage other banks to replicate such success.

Although the findings reported a lower switchover rate, the customers raised their concerns over few issues—high fees or charges, the involvement of *riba* in the banking transactions, and inadequate range of the products and services. These, in fact, bring a set of opportunities to the financial service providers to capitalize on the customers' sentiments and by providing differentiated products with more competitive rates.

The report forecasts a growing competition among the IBs is expected to induce product innovation, technology adoption, and better retail or corporate consumers' responsiveness.

However, the level of satisfaction among the consumers of Islamic banking is higher compared to that of conventional users. It might be driven by the fulfillment of the religious need. That is what the proposed study intends to explore. However, such consumer behavior brings both opportunities and challenges for IBs. The opportunity of attracting consumers seems to be less attractive compared to the challenges of maintaining a faith-based banking operation regarding its investment and other activities. IBs, having successfully fulfilled this expectation, might even promote these ethical activities to maintain consumers' trust, and this might help both attract new consumers (both Muslim and non-Muslim) and retain existing ones. Islamic Financial Service Act of 2013 also stressed the ethical operation of IBs.

Identifying young professionals as the driver of the financial services market, the report, based on customer survey response, prescribed following actions regarding customer retention and attraction:

- Customized loyalty/reward programs to increase high enrollment
- Including alternative channels to strengthen marketing strategies
- Enhancing knowledge of the branch personnel to improve branch capability
- Meeting and promoting *Shari'ah* compliance to achieve consumers' trust

Nevertheless, the report also documented the customers' concern over the pricing of Islamic Finance products.

However, the suggestions put forward by the Malaysia Islamic Finance Report (2015) shall better be evaluated through empirical findings. And

this study intends to assess how effectively banks in Malaysia (both IBs and CBs) are strategizing their marketing initiatives and what future outcome they might expect to receive from such activities.

2.1 Study Framework, Models, and Variables

To address the research question, that is, marketing effort's effect on performance, the study, based on the literature, develops the following framework in reduced form[2]:

In accordance with the study framework, following models have been estimated separately for three sample groups—full sample, IBs, and CBs:

$$DEP_{it} = \beta_0 + \beta_1 MKTG_{it} + \beta_2 MKTG1_{it} + \beta_3 MKTG2_{it} + \beta_4 MKTG3_{it} + \beta_5 MKTG4_{it} + \beta_6 INDDIZE_{it} + \epsilon_{it} \quad (4.1)$$

$$FIN_{it} = \beta_0 + \beta_1 MKTG_{it} + \beta_2 MKTG1_{it} + \beta_3 MKTG2_{it} + \beta_4 MKTG3_{it} + \beta_5 MKTG4_{it} + \beta_6 INDDIZE_{it} + \epsilon_{it} \quad (4.2)$$

$$NII_{it} = \beta_0 + \beta_1 MKTG_{it} + \beta_2 MKTG1_{it} + \beta_3 MKTG2_{it} + \beta_4 MKTG3_{it} + \beta_5 MKTG4_{it} + \beta_6 INDDIZE_{it} + \epsilon_{it} \quad (4.3)$$

These three equations (4.1–4.3) represent traditional market or sales response model, which illustrates that both current and past marketing efforts create a positive market impact for banks. Industry size (INDSIZE) has been controlled for capturing market environment.

$$MSHRM_{it} = \beta_0 + \beta_1 MKTG_{it} + \beta_2 MKTG1_{it} + \beta_3 MKTG2_{it} + \beta_4 MKTG3_{it} + \beta_5 MKTG4_{it} + \beta_6 GRI_{it} + \beta_7 DEPG_{it} + \epsilon_{it} \quad (4.4)$$

Market share, as discussed before, is one of the nonfinancial measures that is driven by a firm's marketing efforts and subsequent market response. Both industry growth and firm's deposit growth have been controlled for market environment and market response.

$$ROA_{it} = \beta_0 + \beta_1 MKTG_{it} + \beta_2 MKTG1_{it} + \beta_3 MKTG2_{it} + \beta_4 MKTG3_{it} + \beta_5 MKTG4_{it} + \beta_6 MSHRM_{it} + \beta_7 GRI_{it} + \epsilon_{it} \quad (4.5)$$

$$ROE_{it} = \beta_0 + \beta_1 MKTG_{it} + \beta_2 MKTG1_{it} + \beta_3 MKTG2_{it} + \beta_4 MKTG3_{it} + \beta_5 MKTG4_{it} + \beta_6 MSHRM_{it} + \beta_7 GRI_{it} + \epsilon_{it} \quad (4.6)$$

Equations (4.5) and (4.6) reflect the positive effect of marketing efforts on bank's financial performance having controlled for market impact (MSHRM) and market environment (GRI).

Table 4.1 presents the list of variables used in this study and the definition and measurement thereof. The Islamic subsidiary of the commercial banking group benefits from the group's administrative and marketing supports. The expenditures are charged to the IBs in a lump sum and are not reported separately in the IBs' financial statements showing what amount of the shared expenses are subject to marketing, administration, etc.

The Net Interest Income (NII) figure needs to be interpreted with caution. We have to be a bit careful while comparing between IBs and CBs regarding NII/TNI, as the former includes the provision for Impairment of Loan/Investment loss in NII, whereas the latter allocates this only to the shareholders.

2.2 Sample Size and Data Collection

Annex 4.1 provides a detailed list of the banks. The list only covers licensed commercial banks, IBs, and international IBs. Based on the availability of data, the study selected five IBs and five CBs. The five IBs in total account for 33 % market share of IB industry, whereas the five sample CBs account for 59 % market share of CB industry. In total, the sample of the study presents around 66 % of the entire banking sector of Malaysia. Concerning the number of banks considered, the study represents 22 % of the total 46 banks operating in the banking industry in Malaysia.[3]

Data have been collected from the unaudited quarterly statements of the respective banks. Quarterly periods have been synchronized to the calendar year January–December, so that first quarter of the year comprises January–March for each bank and so on (Annex 4.2).

Table 4.1 List of variables, definition, and measurement

Variable	*Definition*	*Measurement*
DEP	Deposit from Customers	Log(Deposit)
FIN	Financing and Advances	Log(Finance)
NII	Net Interest Income or Total Net Income	Log(Net Interest Income)
MKTG	Current Quarter's Marketing Expenditures	Log(Marketing Expenditures)
MKTG1	One Quarterly Lag of Marketing Expenditures	Log(Marketing Expenditures$_{t-1}$)
MKTG2	Two Quarterly Lag of Marketing Expenditures	Log(Marketing Expenditures$_{t-2}$)
MKTG3	Three Quarterly Lag of Marketing Expenditures	Log(Marketing Expenditures$_{t-3}$)
INDSIZE	Size of the Industry in Terms of Total Assets (TA)	Log(Industry TA)
MSHRM	Market Share of IBs/CBs in Respective Industry	Log(Bank's TA)/Log(Industry TA)
GRI[a]	Growth Rate of the Sector	Log(Industry TA) – Log (Industry TA$_{t-1}$)
DEPG	Deposit Growth of the IBs/CBs	Log(Deposit) – Log(Deposit$_{t-1}$)
ROA	Return on Assets	Log(Net Income)/Log(Total Assets)
ROE	Return on Equity	Log (Net Income)/Log (Total Equity)

[a]For the full sample, GRI represents growth of the total banking industry. For Islamic Banking Sample, GRI stands for growth of Islamic banking sector, and for conventional banking sample, GRI measures growth rate of the conventional banking sector.

2.3 Model Estimation

As discussed in the sampling section, the study considers an unbalanced panel as opposed to balanced panel. A balanced panel comprises an identical number of cross-sectional units at each point in time, whereas such number varies, that is, total quarterly observations for each bank are not the same for this study.

Broadly, there are two types of panel estimators approaches, namely "fixed effects (FE)" models and "'random effects (RE)" models (Brooks 2014). FE models allow the intercept in the regression model to differ cross-sectionally but not over time, while all of the slope estimates are fixed both cross-sectionally and over time. RE models, on the other hand, behave the same

Annex 4.1 Sample frame: Banks (Commercial and Islamic) as per BNM statistics

	Name	*Ownership*	*Conventional*	*Islamic*	*Islamic Subsidiary*
1	Affin Bank Berhad	L	C		SC
2	**Alliance Bank Malaysia Berhad**	**L**	**C**		**SC**
3	AmBank (M) Berhad	L	C		SC
4	**CIMB Bank Berhad**	**L**	**C**		**SC**
5	Hong Leong Bank Berhad	L	C		SC
6	Malayan Banking Berhad	L	C		SC
7	**Public Bank Berhad**	**L**	**C**		**SC**
8	RHB Bank Berhad	L	C		SC
9	**Bank Islam Malaysia Berhad**	**L**		**I**	
10	Bank Muamalat Malaysia Berhad	L		I	
11	**HSBC Bank Malaysia Berhad**	**F**	**C**		**SC**
12	OCBC Bank (Malaysia) Berhad	F	C		SC
13	Standard Chartered Bank Malaysia Berhad	F	C		SC
14	BNP Paribas Malaysia Berhad	F	C		
15	Bangkok Bank Berhad	F	C		
16	Bank of America Malaysia Berhad	F	C		
17	Bank of China (Malaysia) Berhad	F	C		
18	Bank of Tokyo-Mitsubishi UFJ (Malaysia) Berhad	F	C		
19	Citibank Berhad	F	C		
20	Deutsche Bank (Malaysia) Berhad	F	C		
21	India International Bank (Malaysia) Berhad	F	C		
22	Industrial and Commercial Bank of China (Malaysia) Berhad	F	C		
23	J.P. Morgan Chase Bank Berhad	F	C		
24	Mizuho Bank (Malaysia) Berhad	F	C		
25	National Bank of Abu Dhabi Malaysia Berhad	F	C		

(*continued*)

Annex 4.1 (continued)

	Name	*Ownership*	*Conventional*	*Islamic*	*Islamic Subsidiary*
26	Sumitomo Mitsui Banking Corporation Malaysia Berhad	F	C		
27	The Bank of Nova Scotia Berhad	F	C		
28	The Royal Bank of Scotland Berhad	F	C		
29	United Overseas Bank (Malaysia) Bhd.	F	C		
30	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	F		I	
31	Asian Finance Bank Berhad	F		I	
32	Kuwait Finance House (Malaysia) Berhad	F		I	
33	Alkhair International Islamic Bank Bhd	F		I	
34	Deutsche Bank Aktiengesellschaft	F		I	
35	PT. Bank Syariah Muamalat Indonesia, Tbk	F		I	

as FE as, for each entity, they offer different intercept terms that are constant over time, and therefore, the relationships between the independent and dependent variables are assumed to be the same both cross-sectionally and temporally. To solve the dilemma over choosing FE or RE, the Hausman test has been suggested to test that there is no correlation between unobserved cross-sectional characteristics and included explanatory/independent variables (null hypothesis) (Masih 2009). Failure to accept the null signifies the use of FE model over RE model.

3 Results and Discussion

For all the models, the Hausman test results, at 1 % significance level, fail to accept the null hypothesis that there is no correlation between unobserved cross-sectional characteristics and included explanatory/independent variables. Therefore, the FE model is preferred over the RE model. It shows that the bank specific unobserved cross-sectional characteristics like the business

Annex 4.2 Ranking of Banks (both Commercial & Islamic) based on size

	Bank Name	*Specialization*	*Latest accounts date*	*Country rank by assets, roll.*	*Total Assets th USD Last avail. yr*	*Total Assets th LCU Last avail. yr*
1	**Malayan Banking Berhad - Maybank**	Commercial	09/2015	1	183,204,581	640,300,000
2	**Public Bank Berhad**	Commercial	09/2015	2	98,919,000	345,721,900
3	CIMB Bank Berhad	Commercial	09/2015	3	96,609,329	337,649,600
4	**RHB Bank Berhad**	Commercial	09/2015	4	58,551,389	204,637,100
5	**Hong Leong Bank Berhad**	Commercial	09/2015	5	48,611,731	184,019,700
6	Maybank Islamic Berhad	Islamic	09/2015	6	41,886,810	146,394,400
7	Kumpulan Wang Persaraan (Diperbadankan)-KWAP	Commercial	12/2014	7	31,428,298	109,841,900
8	United Overseas Bank (Malaysia) Bhd.	Commercial	09/2015	8	26,918,226	94,079,200
9	OCBC Bank (Malaysia) Berhad	Commercial	09/2015	9	26,209,586	91,602,500
10	Bank Kerjasama Rakyat Malaysia Berhad	Islamic	09/2015	10	25,552,275	89,305,200
11	**HSBC Bank Malaysia Berhad**	Commercial	09/2015	11	23,747,325	82,996,900
12	AmBank (M) Berhad	Commercial	09/2015	12	23,352,024	86,787,800
13	Affin Bank	Commercial	09/2015	14	17,033,105	59,530,700
14	Standard Chartered Bank Malaysia Berhad	Commercial	09/2015	15	15,460,801	54,035,500
15	Alliance Bank Malaysia Berhad	Commercial	09/2015	16	14,297,000	53,134,800
16	**CIMB Islamic Bank Berhad**	Islamic	09/2015	17	14,267,182	49,863,800

(*continued*)

Annex 4.2 (continued)

	Bank Name	*Specialization*	*Latest accounts date*	*Country rank by assets, roll.*	*Total Assets th USD Last avail. yr*	*Total Assets th LCU Last avail. yr*
17	**Bank Islam Malaysia Berhad**	Islamic	09/2015	18	13,110,358	45,820,700
18	**Public Islamic Bank Berhad**	Islamic	09/2015	19	10,916,223	38,152,200
19	Citibank Berhad	Commercial	09/2015	21	10,767,983	37,634,100
20	AmIslamic Bank Berhad	Islamic	09/2015	22	10,685,268	39,711,800
21	RHB Islamic Bank Berhad	Islamic	09/2015	23	10,332,990	36,113,800
22	Cagamas Berhad	Commercial	06/2015	24	8,428,527	29,457,700
23	Hong Leong Islamic Bank Berhad	Islamic	09/2015	25	6,149,914	23,280,500
24	Bank Muamalat Malaysia Berhad	Islamic	09/2015	26	6,037,401	22,438,000
25	**HSBC Amanah Malaysia Berhad**	Islamic	09/2015	27	4,687,239	16,381,900
26	Bank of Tokyo-Mitsubishi UFJ (Malaysia) Berhad	Commercial	09/2015	28	4,283,434	14,970,600
27	OCBC Al-Amin Bank Berhad	Islamic	09/2015	29	3,910,844	13,668,400
28	Maybank International (L) Ltd	Commercial	12/2012		3,811,700	3,811,700
29	Affin Islamic Bank Berhad	Islamic	09/2015	30	3,640,429	12,723,300
30	Gensource Berhad	Commercial	06/2004		3,485,211	13,243,800
31	Kuwait Finance House (Malaysia) Berhad	Islamic	06/2015	32	2,996,166	10,471,600
32	Deutsche Bank (Malaysia) Bhd.	Commercial	06/2015	33	2,968,641	10,375,400
33	Bank of China (Malaysia) Berhad	Commercial	06/2015	34	2,797,246	9,776,376
34	Standard Chartered Saadiq Berhad	Islamic	09/2015	35	2,772,275	9,689,100
35	Citibank Malaysia (L) Ltd	Commercial	12/2010		2,501,100	2,501,100
36	**Alliance Islamic Bank Berhad**	Islamic	09/2015	37	2,474,828	9,197,700
37	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	Islamic	09/2015	38	2,080,372	7,270,900

Annex 4.2 (continued)

	Bank Name	*Specialization*	*Latest accounts date*	*Country rank by assets, roll.*	*Total Assets th USD Last avail. yr*	*Total Assets th LCU Last avail. yr*
38	JP Morgan Chase Bank Berhad	Commercial	06/2015	39	2,010,215	7,025,700
39	Bank of Nova Scotia Berhad	Commercial	04/2015	42	1,447,937	4,754,300
40	Bangkok Bank Berhad	Commercial	06/2015	43	1,419,518	4,961,214
41	Industrial and Commercial Bank of China (Malaysia) Berhad	Commercial	09/2015	44	1,155,908	4,039,900
42	BNP Paribas Malaysia Berhad	Commercial	06/2015	48	1,047,811	3,662,100
43	Royal Bank of Scotland Berhad (The)	Commercial	09/2015	49	1,022,211	3,572,626
44	RHB Bank (L) Ltd	Commercial	12/2011		1,011,600	1,011,600
45	Mizuho Bank (Malaysia) Berhad	Commercial	09/2015	53	837,880	3,113,980
46	Asian Finance Bank Berhad	Islamic	09/2015	54	818,610	2,861,040
47	Bank of America Malaysia Berhad	Commercial	09/2015	55	753,534	2,633,600
48	Public Bank (L) Ltd	Commercial	12/2014	59	525,317	525,317
49	Bank Persatuan Malaysia Berhad	Commercial	12/2014	60	410,921	1,436,168
50	CIMB Bank (L) Limited	Commercial	12/2014	61	377,600	377,600
51	National Bank of Abu Dhabi Malaysia Berhad	Commercial	06/2015	62	340,372	1,189,601
52	AmINTERNATIONAL (L) Ltd	Commercial	03/2012		310,300	310,300
53	India International Bank (Malaysia) Bhd	Commercial	06/2015	64	131,645	460,098
54	Alkhair International Islamic Bank Berhad	Islamic	12/2014	65	66,667	233,002

Source: Bankscope Database

model, strategy, corporate planning, human capital, resource acquisition ability, management capability, etc. have a contribution in creating difference among the banks and FE is expected to provide us with the consistent estimates. As suggested by Hoechle (2007), Driscoll and Kraay a standard error estimator is robust to disturbances being heteroskedastic, autocorrelated, and cross-sectionally dependent. Therefore, the study reports results using a fixed effects regression (with Driscoll–Kraay standard errors robust) model.

Table 4.2 presents the results for the market impact (Deposit, Finance, and Net Interest Income/Total Net Income) driven by marketing efforts. For deposit model, current period's marketing and industry show significant positive influence for all panel groups. The lagged effect of marketing is only observed for the second lag in case of full sample and Islamic banking. The coefficient for industry size is quite high, implying an industry-led deposit growth. Marketing, for the CBs, seems to create instantaneous response only. The carry-over effect of marketing is absent.

For the finance model, the findings are similar for CBs. For the full sample and IBs, the results improved slightly. Now, both the first and second lag, find its significant positive presence in driving finance. The higher *R*-squared value shows the explanatory power of both the models.

The NII model is a bit complex. As discussed earlier, the NII of IBs and CBs differ by accounting treatment. Therefore, no comparison should be made; instead, a separate evaluation might be pursued. In the case of IBs, the effect of marketing effort (second lag) is still significant. The magnitude of the coefficient of MKTG2 also improved slightly compared to

Table 4.2 Sample size and duration

Bank	*Quarters*	*Duration*
Alliance Islamic	30	2008Q2–2015Q3
Bank Islam	23	2010Q1–2015Q3
CIMB Islamic	23	2009Q4–2015Q2
HSBC Amanah	24	2009Q4–2015Q2
Public Islamic	28	2008Q4–2015Q3
Maybank Commercial	25	2009Q3–2015Q3
Public Bank	35	2007Q1–2015Q3
RHB	27	2008Q4–2015Q2
Hong Leong Bank	29	2008Q3–2015Q3
HSBC	43	2005Q1–2015Q3

Source: Author

other two models. The industry effect is found to be significant, although the coefficient lost its strength to a greater extent. For CBs, marketing efforts show no significant influence on NII. On the top of it, MKTG1 comes up with the wrong sign, although significant. The industry growth has significant positive impact. The R-squared value shows a better explanatory power of the model to capture the variability in the NII. However, the marketing variables do not show any significance in creating market impact for the CBs (Table 4.3).

Table 4.4 presents the market impact created by marketing efforts regarding nonfinancial measures; the market shares of the banks in its respective industry. The findings show both current and past marketing efforts have significant positive impact on increasing market share of the IBs, signifying the carry-over effect of marketing. The other control variables, the growth of Islamic banking and deposit growth of the banks have no significant presence. For CBs, the situation is quite different. Past marketing efforts fail to create any significant change in CBs' market share. Only the current period's marketing efforts help the CBs increase their share in the conventional banking industry, highlighting a significant and instantaneous positive response. The deposit growth shows the significant positive influence Table 4.5.

Lastly, the financial impact of marketing efforts has been explored regarding ROA and ROE. The findings show that the market share significantly positively affects the ROA and ROE. Current marketing efforts are found to negatively affect both ROA and ROE in the case of IBs and CBs. However, past marketing efforts are found to be insignificant.

The findings of the study provide strong support for the study framework (Fig. 4.3), which was developed based on the previous studies. There is an important distinction to note. For IBs, the *chain-of-effect* is clearly visible as marketing exerts both instantaneous and carry-over effects to create market impact in both financial (deposit, finance, and NII) and nonfinancial measures (market share), and subsequently nonfinancial measures (being considered as the long-run component) create the financial impact (long-run impact). However, for the CBs, marketing, through only instantaneous effect, exerts a positive influence on the financial measures (deposit and finance), which along with the instantaneous effect exert further influence on the long-term nonfinancial measures—market share—which then affects the profitability of the CBs. This difference in channel effect has been portrayed in Fig. 4.4.

Table 4.3 Fixed effects regression (with Driscoll–Kraay standard errors robust) models for deposit, finance, and net interest income (total net income)

	Deposit			*Finance*			*Net interest income (Total net income)*		
	Full sample	*IB*	*CB*	*Full sample*	*IB*	*CB*	*Full sample*	*IB*	*CB*
MKTG	0.0587488***	0.0655519***	0.0535694**	0.04183***	0.0432264***	0.0477439**	0.0097064	0.0220294	–0.0007225
	(0.021153)	(0.019269)	(0.021356)	(0.010251)	(0.008899)	(0.022201)	(0.011685)	(0.018051)	(0.015776)
MKTG1	0.0228646	0.026468	0.0139364	0.0213544***	0.0239111***	–0.004449	0.0112707	–0.0013457	–.0244102**
	(0.020790)	(0.020573)	(0.009312)	(0.007202)	(0.008505)	(0.013828)	(0.015264)	(0.029836)	(0.011582)
MKTG2	0.0448862**	0.0438781***	–0.0000667	0.0311023***	0.0291925**	–0.0092179	0.0534041***	0.0755921***	–0.0087583
	(0.017611)	(0.015638)	(0.011967)	(0.008997)	(0.011936)	(0.015580)	(0.019273)	(0.027134)	(0.010499)
MKTG3	–0.0037802	0.0175252	0.0020885	–0.0016066	0.0186729	–0.007938	0.0053336	0.0175632	–0.0107318
	(0.022436)	(0.021976)	(0.011608)	(0.008743)	(0.013153)	(0.018522)	(0.014536)	(0.031587)	(0.014263)
INDSIZE	1.143481***	1.052811***	1.07859***	1.244048***	0.9329533***	1.323876***	0.6327446***	0.2434338***	0.8930619***
	(0.088888)	(0.044457)	(0.058722)	(0.069873)	(0.034112)	(0.059775)	(0.055549)	(0.070563)	(0.056844)
_cons	–3.411257***	–2.340634***	–2.125696***	–4.318876***	–1.261584***	–4.316592***	–0.6444664	2.660205***	–2.147752***
	(0.794633)	(0.436426)	(0.585175)	(0.634529)	(0.282384)	(0.557017)	(0.568463)	(0.683180)	(0.509127)
No. of Obs.	248	113	135	248	113	135	248	113	135
No. of Group	10	5	5	10	5	5	10	5	5
R^2 (within)	0.7632	0.8606	0.8231	0.8152	0.9001	0.7822	0.4654	0.2143	0.7605
F-stat.	*F*(5,31)	*F*(5,26)	*F*(5,31)	*F*(5,31)	*F*(5,26)	*F*(5,31)	*F*(5,31)	*F*(5,26)	*F*(5,31)
	42.92***	132.56***	89.96***	134.81***	449.68***	129.43***	45.35***	4.82***	65.11***

Note: Estimates and standard errors (in parentheses)
*$p < 0.10$, **$p < 0.05$, ***$p < 0.01$

Table 4.4 Fixed effects regression (with Driscoll–Kraay standard errors robust) models for market share

	Market share		
	Full sample	*IB*	*CB*
MKTG	0.0539116***	0.0571822***	0.0817664***
	(0.012317)	(0.013166)	(0.021777)
MKTG1	0.0457562***	0.0404699***	0.0003775
	(0.007533)	(0.012853)	(0.010141)
MKTG2	0.0431844***	0.0413722**	–0.0107402
	(0.012364)	(0.016103)	(0.009135)
MKTG3	0.0253166***	0.040218***	–0.0076517
	(0.005585)	(0.009520)	(0.011035)
GRI	0.4827187	0.4571729	–0.6289691
	(0.565946)	(0.370320)	(0.484813)
DEPG	0.2020259***	0.1145304	0.4016159***
	(0.070222)	(0.131459)	(0.124824)
_cons	0.2190289**	0.1345008	0.7168479***
	(0.091546)	(0.086900)	(0.104471)
No. of Obs.	248	113	135
No. of Group	10	5	5
R^2 (within)	0.2178	0.2777	0.1385
F-stat.	*F*(6,31)	*F*(6,26)	*F*(6.31)
	29.32***	11.84***	3.29**

Note: Estimates and standard errors (in parentheses)
*$p < 0.10$, **$p < 0.05$, ***$p < 0.01$.

It would be premature to comment on which channel effect is better, which is not even the purpose of this study. However, it shows that the performance metrics can be different for both Islamic and conventional to capture the effect of marketing efforts. The framework of the current study suits the IBs' marketing effectiveness well. Nevertheless, given the sample size of the study, it is hard to generalize such a conclusion. Moreover, such a difference, in fact, highlights the importance of considering the strategic choice made by the respective banks. This will enable us to see how marketing adaptive capability (reactor, defender, analyzer, & prospector) affects marketing effectiveness. This might also help the banks to develop a competitive strategy based on rival's strategic choice. Future studies might address this issue. Another missing point, according to RBV framework, is the efficiency and effectiveness of the banks, which might also be considered by future studies.

Table 4.5 Fixed effects regression (with Driscoll–Kraay standard errors robust) models for ROA and ROE

	ROA			*ROE*		
	Full sample	*IB*	*CB*	*Full sample*	*IB*	*CB*
MKTG	–0.0140181***	–0.0168901***	–.0118955**	–0.0136837**	–.0153795**	–0.0150929***
	(0.004812)	(0.005761)	(0.004585)	(0.005388)	(0.006370)	(0.004994)
MKTG1	–0.0026417	–0.0043284	–.0062579*	0.0016082	–0.0007487	–0.0015847
	(0.002568)	(0.003484)	(0.003688)	(0.003642)	(0.004362)	(0.003409)
MKTG2	0.0030925	0.0005896	0.0043555	0.0058199	0.0038308	0.0082593***
	(0.003505)	(0.006248)	(0.002862)	(0.004726)	(0.007182)	(0.002858)
MKTG3	0.0011236	0.0013174	–.0064621**	0.003151	0.0046785	–0.0037576
	(0.004047)	(0.007677)	(0.003062)	(0.004107)	(0.007651)	(0.003071)
MSHRM	0.1374317***	0.2121443***	0.0573944***	0.197365***	0.3255479***	0.0930684***
	(0.029820)	(0.048325)	(0.019574)	(0.030914)	(0.050954)	(0.027818)
GRI	–0.0253428	0.2087164*	0.0756269	0.1369886	0.2703455**	0.0737028
	(0.245547)	(0.105084)	(0.285518)	(0.282930)	(0.110698)	(0.283140)
_cons	0.5979595***	0.5469392***	0.718583***	0.6195029***	0.5405406***	0.772644***
	(0.023884)	(0.033303)	(0.031959)	(0.034739)	(0.045799)	(0.031287)
No. of Obs.	247	112	135	247	112	135
No. of Group	10	5	5	10	5	15
R^2 (within)	0.1520	0.2603	0.1120	0.2231	0.3991	0.0961
F-stat.	*F*(6,31)	*F*(6,26)	*F*(6,31)	*F*(6,31)	*F*(6,26)	*F*(6,31)
	9.55***	7.13***	3.42**	12.51***	14.88***	7.39***

Note: Estimates and standard errors (in parentheses)
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

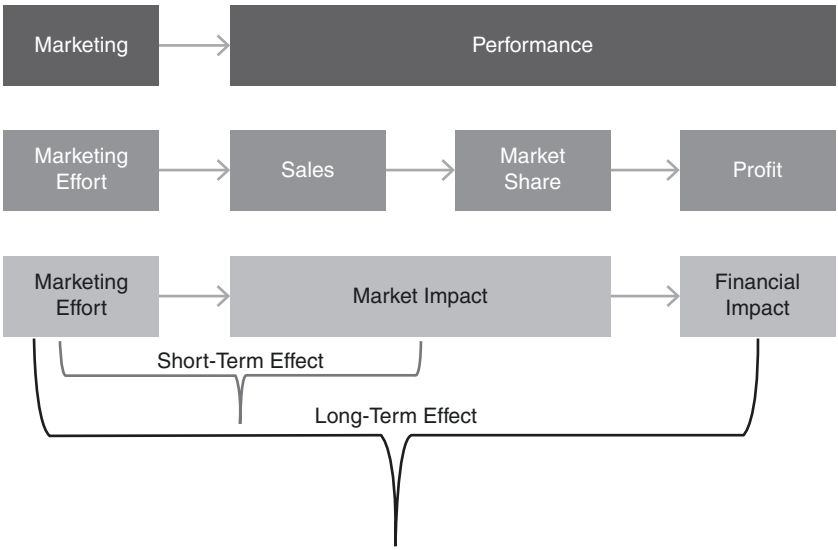

Fig. 4.3 Study framework

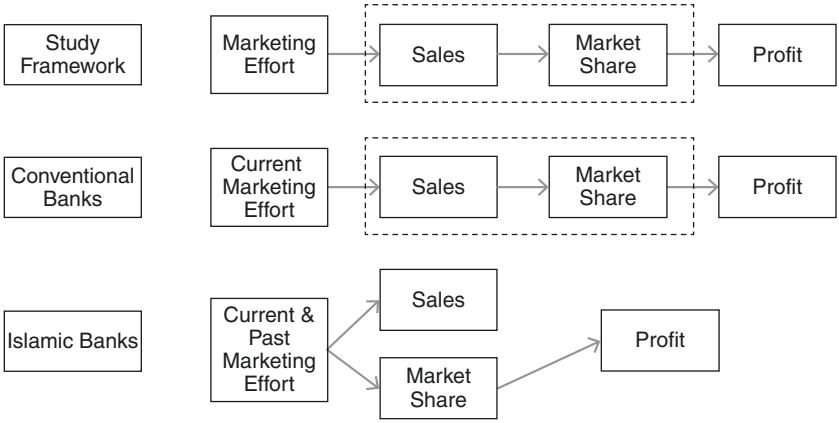

Fig. 4.4 Chain-of-effect for conventional and Islamic banks

4 Summary and Conclusion

The study started with the impression (as reported in the previous studies) that the IBs are weak in crafting its marketing initiatives. However, the findings of the study based on a sample of ten banks (five IBs and five CBs) report otherwise. Perhaps, over time, IBs have come to realize the importance of marketing to strengthen their position in the market and have started addressing the marketing as a meaningful means of communicating with the target customers. IBs are found to benefit from marketing efforts in contrast to CBs. The *chain-of-effect* is different for CBs. However, marketing as an investment possesses the carry-over effect for the IBs and such effect is found to be significant. Maybe, the IBs are still enjoying the dividend from "religious affinity."

From a managerial perspective, the findings of the study support the relevance and importance of both financial and nonfinancial metrics to assess marketing effectiveness. The interrelation of these metrics prove to be insightful for decision-making, especially on allocating the resources to different marketing efforts. Analysis of the contribution of specific marketing activities to the performance of the banks might elicit meaningful findings. It requires data that is internal to the banks (see, Baidya and Basu 2008; Bruhn Tuzovic 2009).

As a preliminary investigation, the study considered broad figures like deposits, financing and advances, and net interest income/total net profit. However, these can be segregated into corporate customers and individual customers and can be further classified into products. A strong base in corporate clients, in fact, allows the bank to cross-sell its consumer banking products to the salaried accounts of the corporate employees. Ahmad and Haron (2002) cited the weakness of the Islamic banking in attracting more corporate customers. Indeed strong corporate base, intuitively, has a positive effect on the bank's consumer portfolio, through the salary accounts and subsequent cross-selling of the banking products.

When the brand building process is underway, marketing efforts could be better capitalized with respect to market penetration and presence in terms of the number of branches, ATMs, KIOSKs, and geographical coverage, etc. The study does not address these issues. Future studies, with a large sample, might combine all these points to portray a comprehensive picture of marketing effectiveness of the IBs.

Notes

1. Three locally owned Islamic banks, namely Bank Rakyat, Bank Islam, and Bank Muamalat share around 27 % of the Islamic Banking industry in Malaysia, whereas the Islamic Subsidiary of Maybank, CIMB, and Public Banking Group dominate with around 41 % thereof. Notably, Bank Rakyat operates under Development Financial Institutions Act 2002. (Source: BNM Website, Bankscope, and Author)
2. Based on the chain-of-effect model, the marketing activities of the firms are expected to create the consumers' awareness (the marketing assets), which creates immediate short-term market impact (sales and market share), and the market impact in fact affects the firms bottom-line creating a financial impact. The study separates sales and market share based on other studies that reported of mediating relationships among marketing effort, sales, market share, and financial performance.
3. In a comprehensive assessment of the performance research on Islamic Banking, **Hasan** (**2004**) emphasized on being cautioned about comparing between Islamic and Conventional Banks due to size factor. The author further noted that the number of banks (n) considered in any study signifies the essence of the sample representativeness of the population rather than the value of the sample in comparison to the value of the population. In that respect, the sample size of this study is quite small to come up with a strong conclusion.

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CHAPTER 5

Contracts, Structures, and Computation Mechanisms of Islamic Bank Retail Financing Products: A Critical Assessment

Buerhan Saiti, Hishamuddin Abdul Wahab, and Khaliq Ahmad

Abstract This chapter discusses Islamic bank retail financing, its instruments, and operations. The discussion demonstrates that it is essential to have a banking system based on *Shariah* principles that fulfill the needs of Muslim consumers. The chapter examines the various personal financing products, their underlying Islamic contracts, and their computational mechanisms with appropriate examples. It also critically evaluates the products of Islamic bank retail financing. The availability of various personal financing instruments in Islamic banks allows Muslim consumers to achieve their financing needs. Moving forward, a greater variety of instruments

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that invite fewer *Shariah* issues must be offered in the market to ensure a more vibrant Islamic banking system.

Keywords Islamic finance · Islamic banking · Retail financing

1 *Shariah* Basis of Islamic Banking

Shariah is the origin and basis of Islamic banking, and incorporates Islamic laws and jurisprudence. In the faith and belief of a Muslim, Islam is the religion revealed by Allah to His last prophet, Muhammad (p.b.u.h.). It is a complete religion, embracing all facets of mundane activities in this world as well as a state of affairs in the world hereafter of believers.

The teaching of Islam includes the essence of economic well-being and development of Muslim at the individual, family, society, state, and "*Ummah*" (Islamic universal community) levels. Fig. 5.1 illustrates the Islamic view of life of a Muslim and the place of his economic activities including banking and financial activities within the framework of such a view (Bank Islamic Malaysia Berhad 1994).

As shown in Fig. 5.1, Islam consists of three basic elements such as *Aqidah, Shariah* Law, and *Akhlaq*. *Aqidah* concerns all forms of faith and belief by a Muslim in Allah and His will, from the fundamental faith in His being to the ordinary beliefs in His individual commands *(Ahkam)*. *Shariah* Law covers all forms of practical actions by a Muslim manifesting his faith and belief. Last but not the least, *Akhlaq* concerns behavior, attitude, and work ethics related to Muslim's practical actions.

Shariah Law as the practical aspects of a Muslim's daily life is then divided into another two categories: *Ibadat* and *Muamalat*. *Ibadat* is concerned with the practicalities of his worship of Allah, in the form of man-to-Allah relationship. But *Muamalat* is concerned with the practicalities of his mundane daily life, in the form of man-to-man relationship. One of the significant segments of *Muamalat* is the conduct of a Muslim's economic activity within his economic system. And within this economic system is the banking and financial system where he conducts his banking and financial activities.

Therefore, in the Islamic way of life and *Shariah* framework, a Muslim's banking and financial activities can be traced to his economic activities, to *Muamalat*, to *Shariah*, to Islam, and finally to Allah. This is the root of Islamic banking and finance.

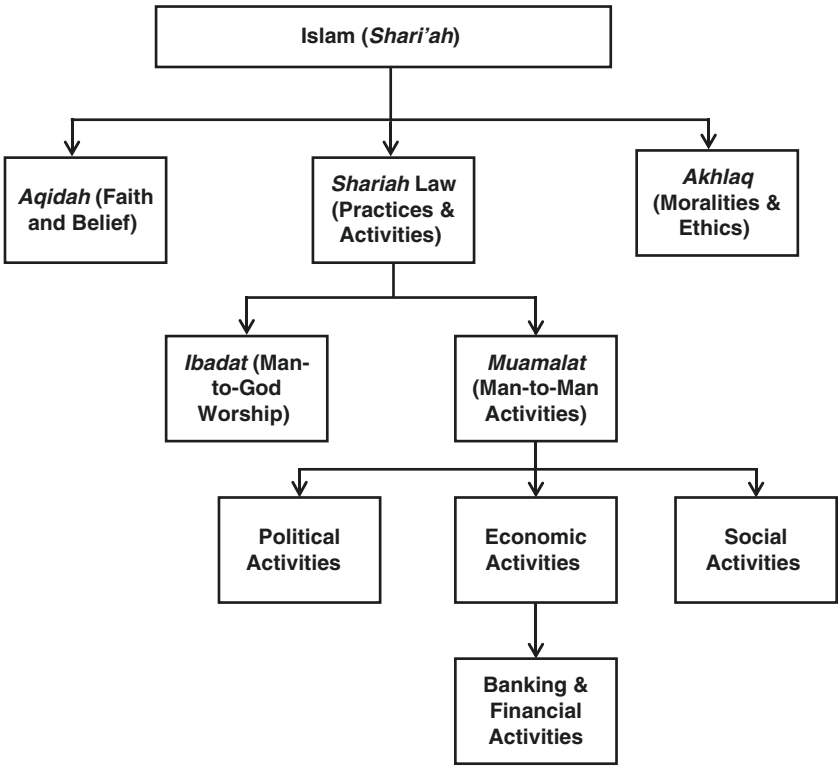

Fig. 5.1 The Islamic view of life of a Muslim

Banking and financial activities being part and parcel of *Muamalat*, are therefore subject to the *Shariah* Laws on *Muamalat*. Our subject matter is the operations of an Islamic bank, which are a part of the financial system, a commercial bank. However, we shall briefly describe the conceptual framework of the Islamic retail banking financing products. Different countries arrange their financial systems differently; and even for a single country the arrangement of its financial system dynamically evolves over time. In this chapter, we take Malaysia as an example, we are going to examine various types of Islamic bank retail financing products.

According to Islam, with regard to equity, a very notable feature of *Shariah* is the fact that al-Quran does not directly deal with it at all (as

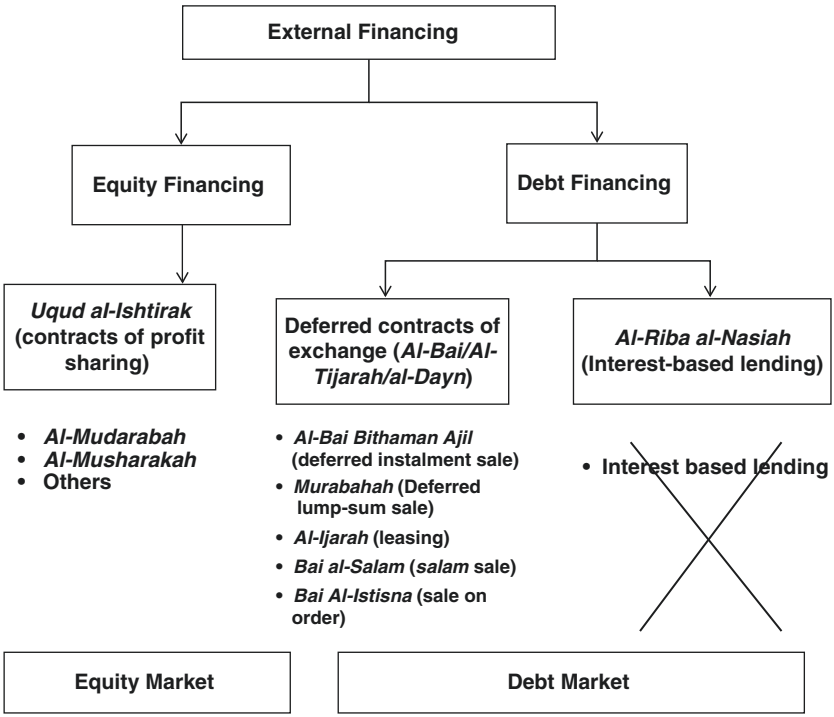

Fig. 5.2 Islamic views on external financing

shown in Fig. 5.2). It was left to *al-Sunnah* to clarify the issue. And *al-Sunnah* confirms that the profit sharing contracts such as *Mudarabah*, *Musharakah* and other similar contracts that had been practiced by the pre-Islamic Arab are all allowed in Islam. Al-Quran is silent on the equity while it comes out strongly on debt. Al-Sunnah also handles extensively with debt. The verdict is deferred contracts of exchange are allowed in Islam; whereas interest-based lending is forbidden.

We derive that Islam permits both equity financing and debt financing. Equity financing is to be conducted through profit-sharing contracts while the debt financing by deferred contracts of exchange. This is indeed the foundation for establishing and developing the Islamic banking and financial system.

Lending is still allowed in Islam, but it has to be without interest. In *Shariah*, this kind of lending is called "*al-Qard Al-Hasan*" (Benevolent

loan). This contract is more relevant in the social welfare sector of the economy.

There are major differences between equity and debt financing in Islamic finance and conventional finance. The major differences arise in equity financing due to the fact that there are no equivalent risk sharing contracts such as *Mudarabah* and *Musharakah* available in conventional finance. In terms of debt financing, the conventional ones deal purely with loan-based contracts, whereas Islamic debt financing mainly focuses on exchange contracts. Debt financing in a conventional system is almost totally based on interest-based lending, while this contract is forbidden in the Islamic financial system. Conversely, the Islamic debt-financing instruments of deferred contracts of exchange are not generally known in the conventional financial system.

The contracts of products and services of Islamic banks can be classified into three main categories: sale-based, partnership-based, and fee-based contracts. As far as the latter two are concerned, there is little objection from an Islamic perspective. The major issue lies in the sale-based contracts.

In the partnership-based contracts, the Islamic bank and the depositors (liability side) and the Islamic bank and the customers (asset side) can enter into Islamic partnership contracts, such as *Mudarabah* and *Musharakah*, to carry out some Islamic banking transactions. In the case of Mudarabah, one party contributes to the entire capital and another party manages the project. If there is any profit, they share according to their predetermined profit-sharing ratio. In the case of loss, the capital provider bears all losses. In other words, they follow a profit sharing and loss bearing principle. In the case of *Musharakah*, both parties contribute some amount of capitals, and one party, let say Islamic bank, manages the project. The distributions of profits or sharing of the losses can be based on the capital contribution ratio or pre-agreed profit and loss sharing ratio. In this contract, the principle of profit and loss sharing is applied.

In the early development stage of an Islamic bank, these partnership contracts are least popular. No one wants to lose the money. Put differently, Islamic banks do not want to lose the depositors' money by entering into partnership contracts with customers. In a similar way, the Islamic bank depositors do not want to lose part of their savings. Based on the Islamic Financial Services Act 2013 (IFSA), there is a clear difference between deposit and investment accounts. In the investment account, depositors have to bear higher risk appetites. Unlike Islamic deposits, which can be withdrawn on demand and guaranteed by Perbadanan Insurans Deposit Malaysia (PIDM), depositors of investment accounts are able to retain

funds for a longer period of time and enjoy the opportunity to earn more returns but with more restrictive withdrawal conditions. And this kind of investment deposit is not guaranteed by PIDM.

In the fee-based contract, the Islamic banks impose fees for the services they offered. These fees are not based on interest rate or not utilizing the interest rate as benchmark. The most popular contract is *Wakalah* contract where Islamic banks as agent to undertake some services. Therefore, there are almost no *Shariah* objections on partnership and fee-based products and services.

However, the application of the abovementioned partnership or fee-based products and services are not popular ones. In other words, they are not major components of the balance sheet of Islamic banks. The main components of Islamic commercial banks are sale-based products such as housing financing, car financing and personal financing. These products are offered based on Islamic contracts *Al Bai Bithaman Ajil (BBA), Murabahah, Parallel Istisna, Tawarruq Musharakah Muntanaqisah, AITAB, Al-rahnu*, etc. Therefore, a critical assessment is needed as far as the Islamic banking products and services are concerned.

The bank is free to utilize the remaining customers' deposits and the portion of shareholders' funds for financing operations after the holding statutory and liquidity reserve requirements. Islamic banks are actively involved in the various sectors of the economy, such as agriculture, manufacturing, construction, wholesale and retail trade, transport, financing and business services, and real estate and housing. They are providing financing facilities to the customers either short-term financing facilities or medium- and long-term facilities under the various Islamic principles. In this chapter, we will look at on some types of the Islamic banks' financing facilities.

2 Housing Financing

As one of the five objectives of Islam (*Maqasid of Shariah*), it cannot be denied that the house is important for human life. And it is also considered basic needs or basic necessity for humans. The following Quranic verses and Hadiths can explain the impotence of shelter from Islamic perspective.

> And Allah has made for you from your homes a place of rest and made for you from the hides of the animals tents which you find light on your day of travel and your day of encampment; and from their wool, fur and hair is furnishing and enjoyment for a time. (Al Nahl 16:80)

> The basic right of the son of man is for three things; house to live in, a piece of cloth to cover his body, a loaf of bread and water. (Narrated Al tirmidhi)

The house is an essential element of human living. Many people cannot afford to buy a house on cash basis. Therefore, they need loans to buy a house in a conventional way. Since Islam prohibits paying and receipt of interest (*riba*), Muslim consumers are seeking for alternative solutions to their needs. Islamic banks started to provide financing alternatives to Muslim consumers since late of last century, such as the first Islamic bank was established in 1983 in Malaysia.

2.1 Conventional Housing Loan

Now let us look at the conventional housing loan before looking at the Islamic housing-financing facilities (Fig. 5.3). There are only two contracts such as sales & purchase (S&P) agreement and loan contract. First of all, the customer signs S&P agreement with the property developer. Then the customer will sign loan contract with the bank if the bank approves the customer's loan application. The modus operandi of conventional housing loan is illustrated in the following sections:

The execution steps:

1. The customer needs to identify the house to be purchased and make down payment to the developer, let say 10 %.
2. The developer promises to sell the house to the customer.
3. The customer approaches to the conventional bank and will apply a loan for the remaining 90 % of the house price.
4. The customer and the bank make a loan contract after the approval of customer's loan application. And the customer will pay the principal and interest on a deferred basis.
5. Now the customer will pay to the developer the remaining 90 % of the house price and owe the house.

However, paying or receiving of interest is prohibited in Islam. Therefore, Islamic banks developed a number of Islamic housing products that are highlighted in the following sections:

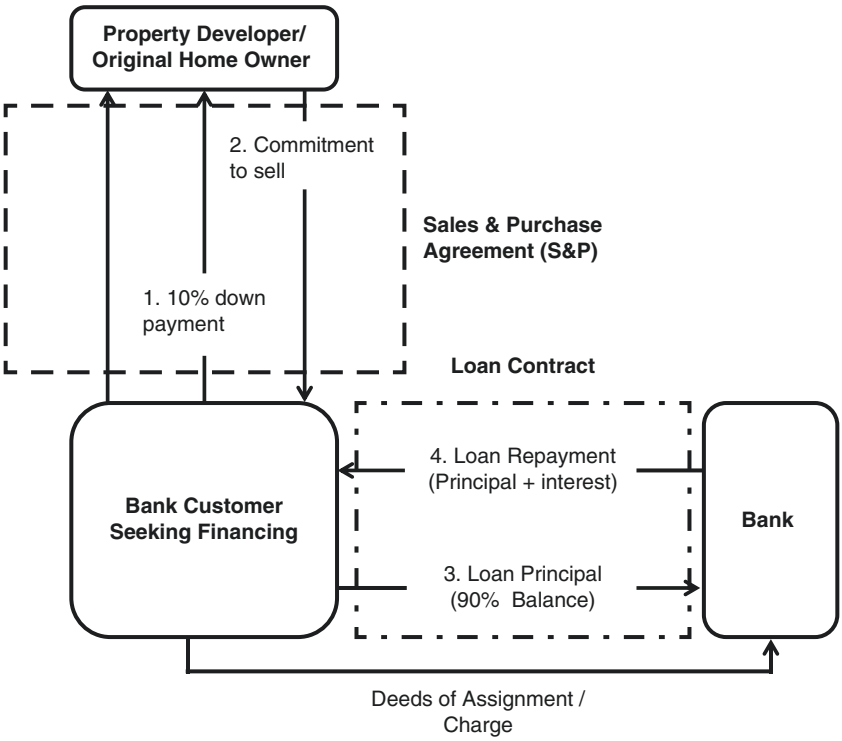

Fig. 5.3 Model of conventional housing loan

2.2 Bay' Bithaman Ajil *(BBA) Home Financing*

In principle, the BBA deals with only two parties, such as the bank as the selling party and the customer as the buying party. In other words, before the BBA takes place, the bank must buy the house from the developer (see Fig 5.4 for modus operandi). However, the current law in Malaysia does not allow the above to take place due to whether Islamic bank or otherwise can only provide financing facilities. Meaning that the law does not allow Islamic banks or conventional banks to buy and sell assets to earn profits. Civil transactions require the customer to buy the house from the developer. The Islamic Banking Act (1983) is a civil law and is under the jurisdiction of the civil court.

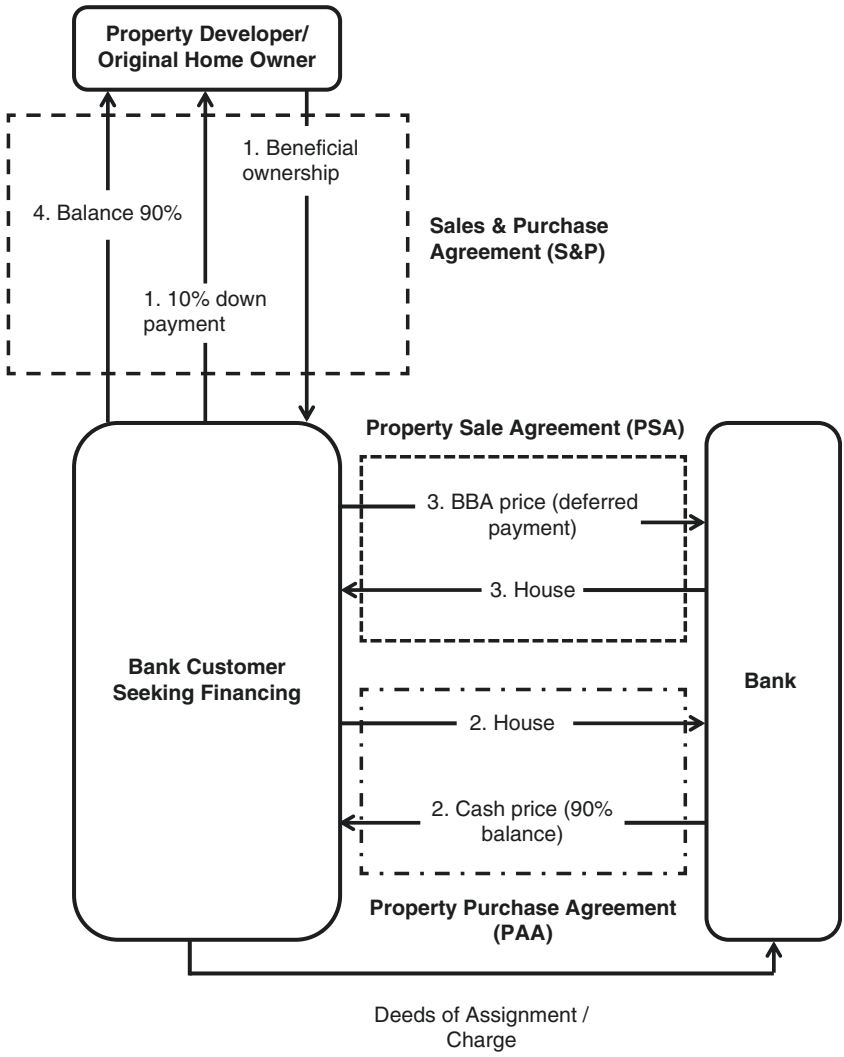

Fig. 5.4 Modus operandi of Bay' Bithaman Ajil (BBA) home financing

We have to differentiate that, in Malaysia, short-term credit *Murabahah* (for the financing period less than 12 months) is simply called *Murabahah* with payment payable lump sum. Whereas, a long-term credit *Murabahah* (for a period beyond 12 months) is known as *Bay' Bithaman Ajil* (BBA). As we know, the housing financing is for long term, therefore, the most appropriate terminology will be BBA for housing financing where the customer can pay by installment payments.

Steps:

1. Under S&P agreement:

   The customer needs to identify the house to be purchased and make down payment to the developer, let us say 10 %.

   The developer promises to sell the house to customer and customer owes the beneficial ownership.

2. Under property purchase agreement (PPA):

   The customer sells the house to the bank for cash.

   The bank pays the remaining 90 % of the property price.

3. Under the property sale agreement (PSA):

   The customer buys bank the house from the bank on deferred payment basis. The price includes the principal and profit of the bank.

   The bank delivers the house to the customer.

   Note: PPA and PSA inseparable, represent one financing facility arrangement. Both contracts executed in succession instantaneously.

4. The customer pays the developer the balance of 90 % of the house price.

The Computation of BBA Home Financing

The standard amortization formula is typically applied in determining

a. Monthly installment payment amount
b. Bank's selling price
c. Bank's total unearned profit

The tools for such calculation include financial calculators, Microsoft Excel's PMT function, and annuity factor tables. Banks typically levy a separate lower Grace Period Profit rate for property under construction. The computation formula and illustration of BBA housing financing are shown in Table 5.1.

Critics on BBA Home Financing

Transfer of Ownership

In BBA home financing, what is actually concerning about its *Shariah* permissibility is the legal maxim "no risk-free return" or "*al-ghorm bil ghonm*" and "in any benefit lies on a liability" or "*al-kharaj bil daman*". This is the requirement of equal counter value or compensation in the contract of *al-bay*. Looking on the PPA, it is clear that the bank transfers liability into the customers and makes bank free from all risks. The purpose of the PPA is to secure ownership (*milkiyah)* of the subject matter (*mahalul aqdi*) by the bank before executing PSA (Abd. Aziz 2013). This argument applies to the principle of "do not sell what you don't own," which avoids the principle of equal counter value in the contract. However, the transfer of the ownership in this contract is just a mere fictitious, due the facts that:

a. The banks never have the desire to own the property
b. The banks own this property only in a very short time, since after the PPA took place, subsequently the property is sold back to the customer via the PSA
c. The name of the bank legally has never been stated in the certificate of ownership.

This modus operandi will allow the bank to avoid the risk of ownership (*daman milkiyah*). Whereas taking risk by owning an asset is one requirement to derive profit from the business. The correct way to do is by practicing *al-bay*, which means the bank need to purchase the property from the developer/vendor and sell to the customer. Although this practice has been successfully applied in the GCC (e.g., by Abu Dhabi Bank and Kuwait Finance House), this is not the case in Malaysia. Islamic banking practice in Malaysia does not enable the Bank to purchase the property directly from the developer/vendor for reasons such as capital

Table 5.1 The computation formula and illustration of BBA housing financing

Installment during the grace period (GP)	$GPP = \left(\frac{F \times P \times No.\ of\ years}{No.\ of\ months}\right)$ where F = Bank's cost P = Profit rate
Monthly installment/installments after GP	$MI = \frac{(F \times P/12) \times (1 + P/12)^n}{(1 + P/12)^n - 1}$ where: MI = Monthly installment F = Bank's cost P = Profit rate n = Financing period in months
Property under construction with grace period	$Bank\ sale\ price = GPP + Total\ MI$
Completed property	$Bank\ sale\ price = Total\ MI$

Table 5.1 (continued)

Illustration:

Completed property

Purchase price of property	RM300,000

The financing amount will be:

300,000 × 0.9 = RM270,000

$$MI = \frac{(270,000 \times 0.05/12) \times (1 + 0.05/12)^{300}}{(1 + 0.05/12)^{300} - 1}$$

MI = 1,578.39

Selling price = RM1,578.39 × 300 months = RM473,517

Unearned profit = RM473,517 – RM270,000 = RM203,517

Percentage of financing	90 %
Tenor	25 years (300 months)
Financing rate	5 % p.a.

Property under construction with grace period

Purchase price of property	RM300,000
Percentage of financing	90 %
Tenor	27 years (including 2 years grace period)
Financing rate	5 % p.a.
Grace period profit rate	3 % p.a.

The financing amount will be:

300,000 × 0.9 = RM270,000

During grace period:

$$GPP = \left(\frac{270,000 * 0.03 \times 2}{24}\right)$$

GPP = RM675

After grace period:

$$MI = \frac{(270,000 * 0.05/12) \times (1 + 0.05/12)^{300}}{(1 + 0.05/12)^{300} - 1}$$

MI = 1,578.39

$$Bank\ sale\ price = GPP + Total\ MI$$

Selling price = RM1,578.39 × 300 months + 16,200 = RM489,717

Unearned profit = RM489,717 – RM270,000 = RM219,717

charges, tax claim, and risk profile. On the other hand, the civil transaction law requires the customer to purchase the property from the developer/vendor. Therefore, the Malaysian Islamic bank follows the usual pathway in which the customer buys from the developer/vendor and only after that can the bank offer financing.

Furthermore, stamp duties are imposed during execution of PSA when the bank sells to the customer, and absence during PPA. The customer has to cover the stamp duties and taxes, whereas the legal fees are borne by the bank. This is evident of true ownership transfer during the PSA but this is not the case during the PPA. There is no true asset sale in PPA because no stamp duties are imposed. It is also observed that there is no movement of title where the customer still holds the ownership in PPA. This infers that the intent of the transaction is to provide "loan" rather than a true BBA sale.

The absence of true selling under BBA can also be proven through financial reporting. Financial reporting becomes one of crucial parameters for *Shariah* compliance since it provides systematic and apparent evidence to assess whether BBA home financing enables a true sale or a fictitious sale (Rosly 2010). The importance of the Financial Reports has been clearly emphasized from the Quranic Verse as follows:

> Never get bored with recording it, however small and large, up to its maturity date, for this is seen by Allah as closer to justice, more supportive to testimony and more resolving to doubt

[Al-Baqara: 2, 82]

Default

According to Malaysian law, default is triggered due to occurrence of following reasons:

1. Failure to pay the monthly payment or any sum of money due and payable to the bank under the BBA facility
2. An act of bankruptcy under the Bankruptcy Act 1983 has been committed
3. If Section 25 (1) of the Islamic Banking Act 1983 is triggered[1]
4. Insanity or death of any of the customer(s)
5. Breach of any terms, conditions, or approval contained in the PSA and the legal documentations.

In the event of default, the property will be put under the charge of the bank. The bank will declare the facility to be cancelled and the customer(s) have to pay the whole bank's selling price and all other sums payable under the BBA facility. It means that if the property is put on auction, the customer will have to bear all the costs during the auctioning process until the new buyer signing the Memorandum of Contract. Only for item number 4, when the customer(s) is deceased or suddenly becomes incapacitated, the *takāful* benefit will be effective. Under the ruling of *Shariah* in Malaysia, the maximum amount of the claim is the outstanding sale price and should not be more than that. Any penalty charges (*gharamah*)[2] obtained as a deterrent measure cannot be treated as income to the bank and have to be channeled to charitable bodies.

In practice, usually the bank will issue reminder to the customer after a series of non-repayments. If payment still not be made the bank has the right to foreclose the property. To mitigate the risk of default or non-performing financing (NPF) the bank can offer the customer the option to reschedule and restructure the financing. However, such options are not stipulated in the legal documentation.

Payment

Different selling prices in one sale are prohibited by *Shariah* as the principle of "*aqd* requires one price in one sale. To solve this puzzle Islamic bank introduced BBA floating rate with *ibra*' feature where the selling price is based on the ceiling profit rate (CPR) of 10.75% per annum. But the monthly installment is calculated based on Effective Profit Rate EPR=BFR±spread per annum on daily rest throughout the facility period. Floating rate means that the periodical monthly installment amount is variable and differs from month to month. The installment is adjusted to reflect any changes of EPR based on the movement of BFR but shall not in any event exceeding CPR of 10.75 % per annum. The floating rate product carries *ibra*' feature. Every month, automatic monthly *ibra*' is given based on the difference between EPR and CPR. At maturity, total installment is computed and should not exceed the original selling price. Without the *ibra*' feature, BBA home financing is labeled as expensive compared to conventional home loan. Therefore, the bank as the seller can give rebates to the customer at its own discretion, to remain competitive with its conventional counterparts. The implementation of *ibra*' in the BBA-floating rate reflects the art of selling where the price is fixed at a relatively higher

rate, then periodically adjusted through *ibra'* to justify the changes in the cost of funds for the benefit of both parties.

For fixed or flat-rate home financing, the contractual selling price and monthly installment will be fixed at a certain rate. Basically, the rate is benchmarked by the expected base financing rate (BFR) throughout the financing period. However, due to pressure by product competitiveness, this fixed rate product is no longer offered by the bank. Often in high-interest regime, the bank will suffer because it cannot increase the price to cover the increase in the cost of funds. To overcome the downside of fixed-rate BBA, the floating-rate BBA is invented. The floating rate is more popular and fair to both parties. If the BFR increase, the bank will be benefited because the burden of higher cost of capital will be passed to customer whereas if the BFR decreases, the customer will be benefited in terms of a lower monthly installment.

Late Payment (*Ta' Wīḍ*)

During the facility period, the *ta'wīḍ* is 1 % per annum on the overdue amount or a minimum of RM1 whichever is higher or any other method authorized by BNM. However, once the facility period is over and the customer still has an outstanding principal balance, the *ta'wīḍ* will be based on the bank's current Islamic Interbank Money Market rate or alternative method approved by BNM. Unlike the conventional practice, the *ta'wīḍ* is not compounded on the principal amount.

In the past, no penalty was imposed in the event of late payments because it will alter the contractual price, thus violating the principle of '*aqd* which required one price in one sale. However, this will create moral hazards among the customer who attempt to pay late because nothing will affect them. While this kind of moral hazards continuously occurred, the Islamic bank will be at risk. As a deterrent for the risk of default Bank Negara has approved 1 % penalty over the outstanding principal balance as compensation.[3] The *ta'wīḍ* may be recognized as income to the Islamic banking on the basis that it is considered as a form of compensation for bank's receivable loss incurred by the customer.

Early Settlement/Redemption of Facility

The BBA home financing offered by Islamic banks usually has lock-in period. During the lock-in period, the customer is allowed to make an early settlement/redemption at the bank's sole discretion. Thus, during

this period, the customer will not benefit from the *ibra*'. The customer will have to absorb the higher accrued profit over the bank's selling price. After the lock-in period, the *ibra*' may be permitted at a higher rate. The clause that grant *ibra*' to customer in PSA for early settlement is mandatory as per BNM requirement in order to protect the customers' rights.[4] However, it is observed that there is missing information here where the rate of discount is not specified clearly in the agreement. Furthermore, there is also clause stated that the *ibra*' computation shall be treated as final and binding which make no transparency to customer on how the computation is done. There is also no room for customer to negotiate, but to accept as it is.

Here, it can be concluded that the *ibra*' for early settlement is at the bank's discretion on how much to be given and the computation is not disclosed. This is different from *ibra*' for monthly installment that was automatically given to the customer in terms of the difference between CPR and EPR. In other words, the bank has the upper hand to decide the *ibra*' for early settlement/redemption and whether or not to grant it, whereas the *ibra*' for monthly installment is guaranteed. Apart from that, partial payment of this facility is also allowed through excess payment of the customer by way of EPF withdrawal or additional payment.

The *ibra'* feature in the sale contract contradicts with *fiqh mu'āmalah*, which prescribes that once the price is fixed, both parties have to honor the price. However, this feature is approved by *Shariah* Advisory Council[5] with the aim to keep the Islamic bank competitiveness against conventional bank as well as to protect the public interest. It affects the customer if they have to pay the whole profit amount accruing to the bank although the financing period is shortened. So, it makes no difference whether the customer settles the debt obligation earlier or longer because they have to pay the whole selling price. Unlike the conventional manner, a home loan can be terminated at any time. The income of the bank is based on the interest rates charged during the tenure. The lesser the loan tenure, the lesser the interest charged. The customer gains more if they opt for early settlement. Consequently, the Islamic bank has to be in line with conventional practice that does not contradict *Shariah* in order to remain competitive. Therefore, Islamic bank promises to give *ibra*' to protect the interest of the public that stipulated in PSA under the method of payment section. According to Bank Negara Malaysia, the *ibra*' feature for early settlement is derived from the concept of *dha*' *wa ta'ajjal*, which is allowed in *Shariah*. The inclusion of a clause on

a promise to give a rebate upon early settlement in the PSA solves the price uncertainty issue (*gharar*).

2.3 Musharakah Mutanaqisah *(Partnership with Declining Ownership) Home Financing*

Musharakah Mutanaqisah can be defined as a form of partnership in which one of the partners promise to buy the equity share of the other partner gradually until the title of the equity is completely transferred to him. The transaction consists of four contracts.

- First, a bank and a customer form a joint partnership in the asset "*shirkah al-milk*."
- Second, customer rent the bank's undivided share in the property through the *ijarah* contract.
- Third, *Wa'ad*—the customer will sign the purchase undertaking (*wa'ad*) agreement whereby he agrees to gradually buy the shares from the bank.
- Finally, the customer will gradually buy the bank's share through the contract of "*bay*"

The contract applies mostly in property venture, asset acquisition, and business working capital. The modus operandi of *Musharakah Mutanaqisah* home financing is illustrated in Fig. 5.5.

1. The Customer identifies the property, and negotiates pricing and the terms of sale with the vendor, then signs S&P agreement, pays a deposit (10 %), and applies for the financing.
2. A customer approaches the bank to request for property financing. Once an application approved, the bank issues a letter of acceptance, indicating the bank's agreement to become a musharakah partner with the customer. Solicitors will prepare a *musharakah* agreement detailing the terms and conditions, including the *ijarah* agreement and the share purchase agreement. Finally, bank and customer sign the *Musharakah Mutanaqisah* Property Financing Facility Agreement.
3. The customer holds the property on trust for the *musharakah* partnership under a deed of trust. Customer leases the bank's share in the house.

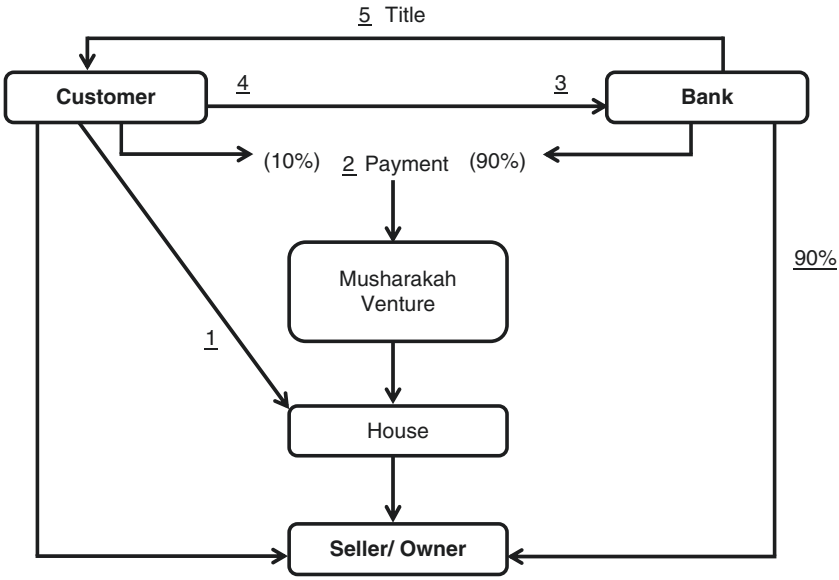

Fig. 5.5 The modus operandi of *Musharakah Mutanaqisah* home financing

4. The customer will pay an amount in addition to the rental to buy the bank's units in the property.
5. Once all periodic payments as per the facility agreement has been made, the *musharakah* and *ijarah* agreements are terminated, and the customer will become the sole owner of the property.

The Computation of Musharakah Mutanaqisah *Home Financing*

Table 5.2 illustrates the computation mechanism of *Musharakah Mutanaqisah* home financing.

The critics on Musharakah Mutanaqisah *(MM) Home Financing Transfer of Ownership*

In contrast to BBA financing in the previous section, the ***Musharakah Mutanaqisah*** (MM) home financing applies contractual partnership of ownership, where both parties, bank (lessor) and customer (lessee), will hold ownership of the property in accordance with equity share. During

Table 5.2 The computation mechanism of *Musharakah Mutanaqisah* home financing

Computation of MM financing

$$MI = \frac{(F \times P/12) \times (1 + P/12)^n}{(1 + P/12)^n - 1}$$

where
MI = Monthly installment
F = Bank's cost
P = Profit rate
n = Financing period in months

Property Price	RM500,000
Bank's Initial Equity	RM450,000 (90%) (F)
Customer's Initial Equity	RM50,000 (10%)
Tenor	25 years (300 months) (n)
Rental Rate	6% (P)

$$MI = \frac{(450,000 \times 0.06/12) \times (1 + 0.06/12)^{300}}{(1 + 0.06/12)^{300} - 1}$$

$$MI = \text{RM2,899.36}$$

Breakdown of Installments:

$$\text{Rental (Ijarah) component} = \frac{\text{Rental rate} \times \text{bank financing}}{12}$$

$$\text{Rental (Ijarah) component} = \frac{0.06 \times 450,000}{12}$$

$$= \text{RM2,250}$$

Equity component:

$$\text{Equity component} = MI - \text{Rental}$$

$$\text{Equity component} = 2,899.36 - 2,250$$

$$= \text{RM649.36}$$

the repayment period, this equity share will be changed gradually where the lessee goes on purchasing the share of the bank in accordance to the market value valuation during the sale of units of the asset. At the same time, the rental of remaining units is expected to decrease accordingly until the ownership is fully transferred to the client.

When it comes to partnership of ownership, by right both parties should bear all expenses and costs related to the ownership on a pro rata basis. Following the saying of Ali bin Abi Talib, "Profit should be according to what they (partners) stipulated, and the loss should be proportionate to

both funds." Comparatively, this feature seems to be unattractive to the bank compared to the BBA financing. As shown in BBA, it seems that the bank is not willing to share the risk together with the client. The same notion also applies to the MM. In simple argument, most financial institutions including Islamic financial institutions have no intention to bear any kind of risks related to their financing facilities. In the case of the MM, it seems that banks are not ready to bear several property-related problems such as tear and wear, damages to the property due to natural disasters such as flood and earthquake. All these problems can be incorporated inside term and agreement of the contract, for sure, but need to be clarified and addressed accordingly (Meera and Abdul Razak 2005). Additionally, mortgage insurance or Takaful may be adopted to cover major losses due to external factors.

Risk

Besides co-ownership risk, the MM exposes the financial institution to credit and operational risk (Akkizidis and Khandelwal 2008). Credit risk comes to surface when the bank does not receive rental payment and the purchase of the equities from the customer. The NPF problems of Musharakah Mutanaqisah Model (MMP) are driven by several reasons such as abandoned projects, partner's business failure, economic downturn, a variation in the rental rate. The problem of rental becomes major issue that clamping down the success of MM (Meera and Abdul Razak 2005). The bank is not interested to offer MM because it is very hard to see an annual rental rate can reach up to 10 % that requires 10 years' rentals to be equivalent to the original price. Thus, MM is perceived to be appropriate to housing cooperatives, where the funds are coming from the members themselves and the MM can provide returns to the members in the form of rentals and property's sale. Besides, rental rate is also based on the market rental rate, which strongly depends on the strategic location. It is challenging to advise the buyer to pay for a higher rental and the process of rental revaluation in several locations may be cumbersome and costly. In terms of operational risk, the bank is expected to monitor the musharakah investment more thoroughly. The bank has limited technical expertise to verify the progress of business activity and may not perform adequate due diligence in appraising venture to be financed and the screening of the risk profile of the customer (Archer and Abdel Karim 2007).

2.4 *Parallel* Istisna *Home Financing*

Istisna can be and has been used in the financing of the purchase of real estate from property developers on the basis of "sell and build." Because the property is still under construction or yet to be constructed at the point of sale, use of the *BBA* contract has been deemed unsuitable. Therefore, a parallel structure is used given that the bank has no competencies to build houses. The bank engages a third party (contractor) and essentially subcontracts the construction work. It is important that the two *Istisna* contracts are independent of each other:

- ✓ In the event that the contractor fails to deliver or delivers but with defects, the bank must be liable to the customer.
- ✓ The bank has contracted to deliver the house to the customer as per stipulated and agreed specifications and must do so regardless of whether the contractor delivers.

The modus operandi of Parallel *Istisna* home financing is described in Fig. 5.6.

1. The customer appoints the bank (acting as a contractor) to undertake a project. Here, the customer will sign an *Istisna* agreement (first *istisna*) with the bank.
2. Then, the bank enters into another parallel *Istisna* (second istisna) contract with a sub-contractor to construct the project and pays the cost of construction; the two *Istisna* contract must remain independent.
3. Developer delivers the completed project (house) to the bank.
4. The bank deliver the house and the customer pay the installment.

The computation of Parallel *Istisna* home financing is similar to the computation of BBA home financing with a grace period. As it explained clearly above, we will not show illustration here.

The critics on Parallel Istisna *Home Financing*

The decision made by an Islamic bank to propose *Istisna* mortgage-based financing as an alternative to the *Musharakah* financing provides feasible alternative for the underconstruction project. The announcement of the new *Istisna* mortgage-based contract was introduced due

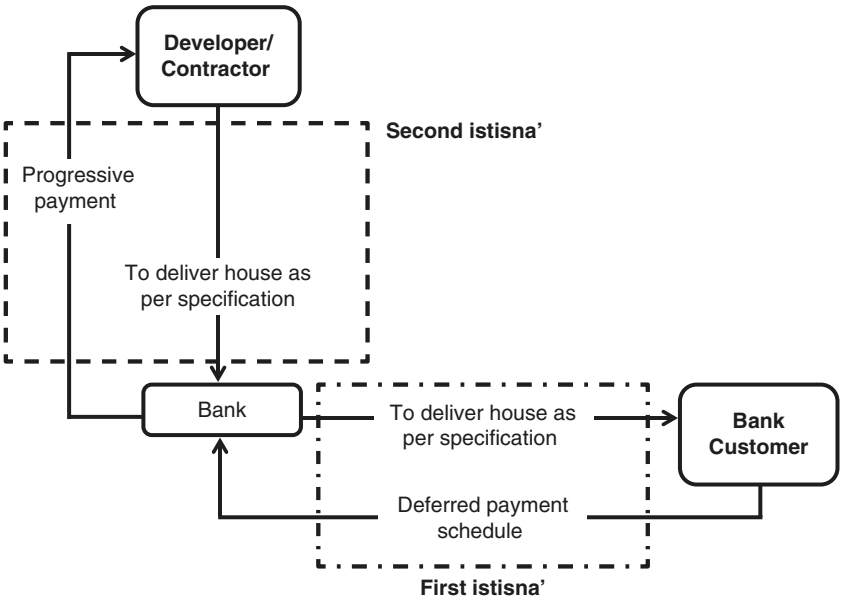

Fig. 5.6 The modus operandi of Parallel *Istisna*' home financing

to an unacceptable level of credit risk in *Musharakah* financing. However, it does not mean that *Istisna* financing is free of credit risk. From our view, the bank facing double credit risks translated in direct *Istisna* (settlement risk) and Parallel *Istisna* (delivery risk). The consequences of this credit risk exacerbated in a sluggish economy. Besides that, the agency problem and asymmetric information problem can be the catalysts to severe credit risk in *Istisna* financing contract. Several possible solutions have been introduced, such as embedding option (*Khiyar al-Shart*), penalty (*ta'widh*), and rebate (*ibra'*) as alternative solutions to mitigate the severity of credit risk in *Istisna* financing.

The *Shariah* Permissibility of *Istisna*

Istisna involves the sale and purchase transaction. According to Ayub (2007), *Bai' al-Istisna* is categorized as future sale with an order to manufacture within the stipulated periodic payment. In general, the sale of nonexistent and non-ownership by the seller on the subject matter is

forbidden according to Hanafis.[6] However, in order to facilitate certain types of business in the modern complex economy, an exception is given through *Istisna* contracts as long as it has been continuously practiced without condemnation. The sale is a noticeably special case in nature. The permissibility of *Istisna* is derived from Hadith, which mentions the manufacturing order for a platform for preaching and a finger ring requested by Prophet S.A.W (Mohamed Ibrahim 2009). Most jurists reasoned by jurist preference (*istihsan*) for the permissibility of *Istisna*, which alternatively translated as a commission to manufacture (Mansuri 2006). The absence of *Istisna* financing can cause adverse impact and stagnation within Muslim economies as most industrial projects and infrastructure cannot be sustained without it, which subsequently hampers the growth of Muslim economy.

Quality of Subject Matter: Goods (*Al-Masnoo*)

The nature of the conditions of the subject matter (*al-Masnoo*) are quite congruent with the Salam contract with regard to the specification of kinds, type, quality, and quantity of goods.[7] The *al-Masnoo* must be specified by its kind (such as a car), type (such as a Proton) with specific quality (specs and performance of the model of Proton) and the quantity.[8] The specification should not be narrowed by the seller only, but perhaps can be specified by the buyer. In addition, quality and quantity should be agreed in absolute term which implies that these two elements should be in measurable and traced form. The extra condition is that the subject of *Istisna* must be a concrete thing that needs to be manufactured. It is not permissible for the *al-masnoo* to be finished goods at contracting time since it violates the essence of *Istisna* contract that requires a manufacturing process to take in place (Ayub 2007). The manufacturer also agrees to transform the raw material to the production of *al-Masnoo* with the condition that the raw material does not fall into the set of items impermissible under Shariah, such as pork and liquor. The nature of the goods also should be unique, which infers that there is no substitute for the goods in the open market and that there is no regular market for the *al-Masnoo* (Ayub 2007). If the goods are widely available in the open market, there is no need for the order to manufacture (*Istisna*) because the buyer can easily purchase the finished goods directly in the open market through normal *bay'* (sale) without the need for waiting and bearing the risk of non-completion of the commodity in *Istisna*.

Time of Delivery

There is disagreement regarding fixing the delivery date for *Istisna* within Hanafis school. According to Imam Abu Hanifa, he argued that the time for project completion should not be fixed, which is underpinned by the rationale that it will transform the characteristics of *Istisna* to imitate the Salam contract if the fixation of delivery date taken into place.[9] In contrast, the followers of Hanafis school (such as Abu Yusuf and Mohammed bin Al-Hassan Al-Shabani, companions of Imam Abu Hanifa) do support the view of the importance for fixing the time of project completion with the justification that the people have practiced such that way for *Istisna* for a long time[10,11] and due to necessity have disregarded common practice.[12] The future delivery date is contingent on the mutual consent of the two parties. The necessity factor here may be justified avoid nondelivery and to ensure that the progress of the work is in accordance with the time plan stipulated by the manufacturer and to minimize additional transaction costs triggered by late delivery. The time frame also becomes beneficial as motivation for the manufacturer to produce the goods in a systematic way and to avoid from the propensity of moral hazard by the manufacturer.

Termination of *Istisna*

The termination of an *Istisna* contract will be taken into effect when the normal obligations of both parties are fulfilled.[13] The buyer (Al-Mustasni') managed to service his obligation diligently while the Al-Sani has manufactured al-Masnoo within the stipulated time frame with conformity to the specification of the goods. The contract can be terminated when there is mutual consent by both parties.[14] For instance, due to extreme climate change, the project on building a bridge cannot proceed. In this event, if the manufacturer request for termination of the contract and get consent from the Al-Mustasni' after the payment made by the buyer has been returned, the termination is deemed valid. The rescission of the contract can also be inflicted by the judicial order where there is a legal hindrance towards execution of the contract.[15] The nullification of the contract also can be triggered from the defect status of the subject matter.

The Agency Problem

The principal–agent conflict has strong connection with operational risk since that the negligence of an agent (manufacturer) enlarges the propensity of delivery risk. This agency problem has great potential to occur in

parallel *Istisna* due to asymmetric information between buyer, Islamic bank, and entrepreneur. People always ignore the agency issue under this contract, which can have tendency to magnify the degree of business risk. When the manufacturer acts as an agent for the Islamic bank, the entrepreneur has a higher propensity to invest in risky projects at the expense of Islamic bank as the financier will be responsible for bearing all losses during the economic downturn. In the major stream of finance, the incentive to invest in more volatile projects can be regarded as a risk shifting problem, which was widely discussed by Jensen and Meckling (1976). The nature of the risk-shifting problem defined within the finance world seems to have similarity with agency conflict between Islamic bank (principal) and manufacturer (agent).

The asymmetric information problem (transparency issue) also tends to enlarge the moral hazard incentive by the entrepreneur as the financier knows too little about the risk profile of the project. In addition, the degree of moral hazard escalates due to separation control as the financial institution has no right to interfere or control the underlying project. A contract, as it is, should be fair to all the counterparties. In this case, "fair" does not mean same return or profit to all the counterparties. "Fair" refers to a justifiable level of transparency of the information to all the counterparties, so that all of them have a common understanding about the nature of the risks related to the manufacturing business. This is why mutual agreement is important. In terms of *Shariah*, the return must be shared based on the risk accordingly and one must not take advantage of the other's lack of knowledge.

In direct *Istisna*, the asymmetric information problem arises when the bank fails to capture the risk profile of the customer. This problem is always associated with an adverse selection problem. On the other hand, in parallel *Istisna*, Islamic bank normally becomes a capital provider without expertise and provides the capital to a manufacturer. In this case, the bank is exposed to the risks arising from the asymmetry information and has limited capability to access information and to participate in the decision-making process during the tenure of a project.

Risk of Nonperformance of *Istisna* Contract

The risk of nonperformance in *Istisna* contracts may exist in both stages of *Istisna* contracts; that is, direct *Istisna* and parallel *Istisna*. The first type of risk in direct *Istisna* contract refers to the risk of counterparty's failure to meet their obligations in terms of facilitating deferred payment

to the bank when the manufacturing work is in progress. The second type of risk in parallel *Istisna* triggered when the manufacturer or contractor may default in reaching agreed quality of goods or may default in delivering goods at an agreed time (Akkizidis and Khandelwal 2008). This delivery default causes problems for Islamic banks because they have to find substitutes for the commodity in the open market that have similar attributes in the contract to meet delivery obligations to the customer. As a result of this nondelivery, the Islamic bank will be exposed to price risk, as the price in open market might be higher than the contracted price.

2.5 Tawarruq *Home Financing*

Tawarruq home financing is essentially cash financing with the proceeds used to finance purchase of property. The transaction is backed up by commodity such as crude palm oil. The most popular mechanism of *Tawarruq* home financing as follows (Fig. 5.7):

1. The customer identifies a house from the developer and pay 10 % down payment.
2. The customer applies for financing and the bank assess his application.

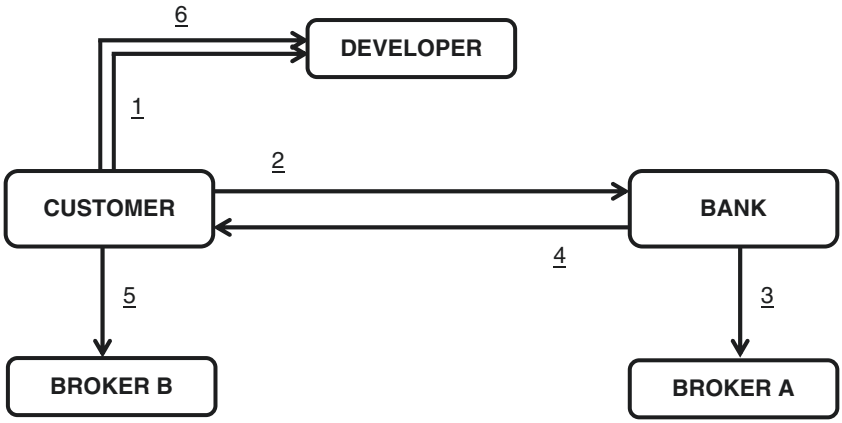

Fig. 5.7 The modus operandi of *Tawarruq* home financing

3. The bank buys the commodity from broker A, costing say RM300,000
4. The bank sells the commodity to the customer for RM450,000. The customer will pay the amount of RM450,000 to the bank by installment throughout the financing period.
5. The customer sells the commodity to broker B and gets cash RM300,000.
6. The customer pays the remaining 90 % balance to the house developer.

The Critics on Tawarruq *Home Financing*

Under the plain definition, *Tawarruq* home financing facility involves *mutawarriq* (customer) who approaches *muwarriq* (bank) to apply for home financing (usually 90 % financing) that involves the process of buying and selling commodities in the market. After home financing approval is granted, the bank will buy the commodity from broker A. After that, the bank sells the commodity to the buyer at a cost plus profit in deferred basis. After getting the commodity, then the customer will appoint a bank as an agent to sell back the same commodity where the bank will sell the commodity at third party (broker B). The proceeds from the sale to broker B will be given to the customer (or direct to developer) in the form of cash for finished property or progress payment (for new property). Although the actual process of *Tawarruq* requires exchange of commodity, it seems customer does not bother about buying and selling the commodity as his intention is to gain financing at first place. This phenomenon asserts the lacking of material association between the customer and commodity that mirror artificial buy–sale and mimics *ribawi* transaction (Haneef 2009). Furthermore, *Tawarruq* facility becomes the subject of argument in terms of ownership of the commodity by the bank. Normally, the process of buying and selling commodities in national or international commodity exchange involves a group of brokers (dealers) who have great expertise in the commodities transactions. It seems that the process of buying–selling commodities always remains where there is the absence of true transfer of ownership from the seller and buyer that increases the vulnerability of *Shariah* restrictions (Ayub 2007). Besides that, the bank is also not ready to bear the risk related to ownership of the property, the same issue that arises under the BBA and MMP home financing facilities.

3 Vehicle (Automobile) Financing

Vehicle financing is another common product offered by Islamic banks. The most well-known structure is *Al-Ijarah Thumma Al-Bay* (AITAB). The details of this product structure shall be discussed in the following section.

3.1 Al-Ijarah Thumma Al-Bay *(AITAB) or Islamic Hire Purchase*

AITAB financing or Islamic hire purchase can be defined as a contract of lease which is subsequently followed by a sale contract. Fig. 5.8 depicted the AITAB financing modus operandi:

The AITAB financing modus operandi is as follows:

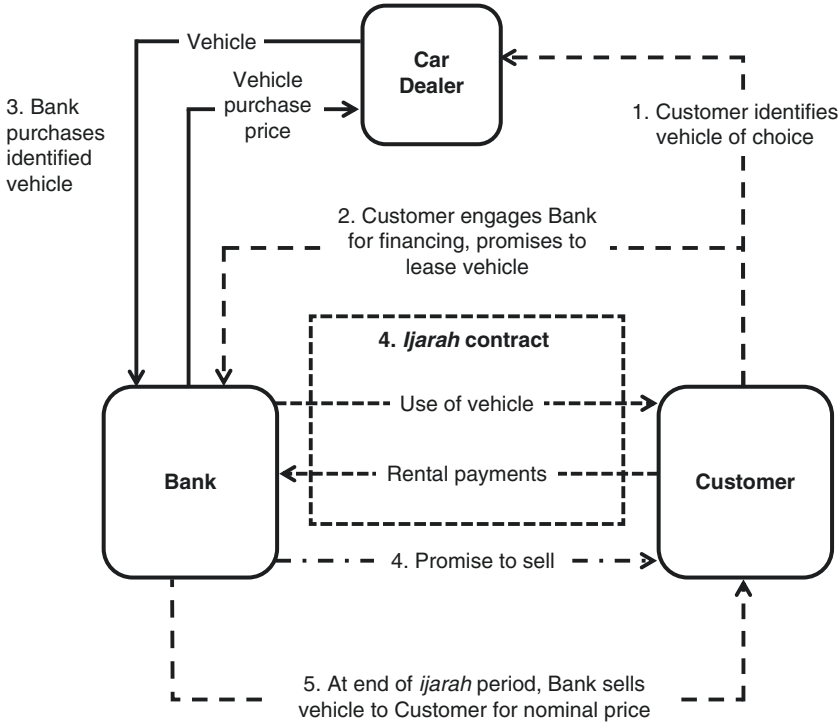

Fig. 5.8 The modus operandi of the *al-ijarah thumma al-bay'* (AITAB) financing

1. The customer identifies a vehicle to purchase and pay a deposit to the vehicle dealer. The deposit considered as advance payment made by the customer.
2. The customer applies for the vehicle financing and undertakes to purchase the vehicle once the bank has purchased it from the car dealer.
3. The bank buys the vehicle and takes ownership of the vehicle from the dealer.
4. Then, the bank enters into an AITAB agreement with the customer in which the customer shall lease the car from the bank against a specified rental for a certain fixed leasing period. At the same time, the customer undertakes to buy the vehicle at the end of the leasing/financing period.
5. At the end of leasing period, a sale contract shall be executed with nominal price to affect the transfer of ownership of the car to the customer.

The Computation Mechanism of AITAB Car Financing

For the computation of AITAB car financing Rule 78 is applied. Under Rule 78, profit is calculated for the life of the financing and then allocated to each month in proportion, using the reserve sum of the digits methodology. We can start by adding up the numbers of months for the note. For instance, in a 12-months financing model, counting month 1, month 2, and so on through month 12 = 78.

$$1 + 2 + 3 + 4 + 5 + 6 + 7 + 8 + 9 + 10 + 11 + 12 = 78$$

Finally, we divide the total profit by the sum of digits (78) and apply in reverse proportions. The computation mechanism of AITAB vehicle financing is illustrated in Table 5.3.

The Critics on AITAB Vehicle Financing

There are several issues pertaining to the leasing contract of AITAB such as ownership-related costs, credit risk, market risk, operational risk, and *Shariah* risk. In common practice, it is a norm that the burden of the asset falls on the lessee, despite a *Shariah* ruling that clearly states the burdens should be borne solely by lessor, as the repairs can benefit the lessor.

Table 5.3 The computation mechanism of AITAB vehicle financing

Formula	*Computation*	
$Total\ Profit = Financing\ Amount * Profit\ Rate * No.\ of\ years$	For example:	
$MI = \frac{Financing\ amount + Total\ Profit}{Tenor\ of\ Financing\ (in\ months)}$	Cost of vehicle	RM100,000
	Down payment	RM10,000 (10%)
	Profit Rate	4 % p.a.
	Tenor	9 years (108 months)
	The financing amount: RM90,000	
	$Total\ Profit = 90,000 * 0.04 * 9$	
	$= \text{RM32,400}$	
	$MI = \frac{90,000 + 32,400}{9 \times 12}$	
	$= \text{RM1,133.33}$	

The transfer of ownership-related costs to lessee causes injustice as it enriches the lessor (Ayub 2008). This problem again mimics the problem of MMP and BBA, where financial institutions are unwilling to absorb ownership-related operating costs. This practice shows the failure of a financial institution to grasp the spirit of *Ijarah* principles that require the bank to own the asset before becoming the lessor of the said asset. Credit risk happens in a situation wherein the customer fails to facilitate the lease rental when it falls due. One of plausible reasons for the default incidence is the variability of the rental rate (floating rate) where a slight increase in rental causes inability to lessee to honor the rental payment (Akkizidis and Khandelwal 2008). In common practice, the bank usually will repossess the asset when customer defaults. This repossession due to early termination of the lease agreement has the potential to expose banks to market risk where the bank needs to lease the asset to a third party at a lower rental rate than the original rate. In the event of vehicle's major damage or maintenance caused by the lessee due to negligence during the possession of the lessee, there might be a tendency for the lessee to refuse from recovering the damage and causing default in the rental payment. In this situation, the bank should be able to take legal action against the lessee and repossess the asset. In the event of damage of the leased asset due to other accidental factors, the lessor must be liable to provide an alternative asset to the lessee. If the bank fails to honor the lessee with alternative asset, the lessee has the right to not make a rental payment for the remaining duration of the contract. Repossession of the leased vehicle might raise legal risk to the bank in respect of the enforcement of its contractual right in case of misconduct and default. The bank is also exposed to *Shariah* risk when the tenant is using the vehicle for illegal activities from *Shariah* perspective, such as selling liquor, selling pork, robbery, and prostitution. Lack of scrutiny in a business undertaking by the lessee exposes the bank to absorb non-permissible income and the bank will need to repossess the vehicle and find a new potential lessee (Archer and Abdel Karim 2007).

4 Personal Financing

In most cases, personal financing does not entail any asset acquisition. Rather, customers need cash for many reasons such as to pay medical expenses, marriage, and paying back existing debts. Therefore, Islamic banks are required to introduce personal financing products which are based on the principles such as *bay' al-inah, buy' al-tawarruq*, and *Rahn*. The following sections will discuss these three mechanisms.

4.1 'Inah Personal Financing

Bay' al-Inah is defined as a sale with immediate repurchase. It involved the sale and repurchase transaction of an asset by a seller (Islamic bank). For example, when a seller (Islamic bank) sells the asset to a customer on a deferred basis and later the seller will repurchase the same asset on a cash basis at a lower price than the deferred price. The following figure (Fig. 5.9) depicted the *inah*' personal financing modus operandi.

The '*inah* personal financing modus operandi is as follows:

1. The customer approaches the Islamic bank for financing.
2. The bank identifies the asset that will be traded under *bay' al-'inah* contract.
3. The bank and customer sign a first sales and purchase contract where the Islamic bank sells the asset at a selling price (financing amount plus profit margin) on deferred terms and the ownership is transferred to the customer.
4. The bank and the customer sign a second sales and purchase contract where the bank buys back the asset sold to the customer at a cost price and pays on cash basis.
5. The customer begins to pay his installment to the bank on a deferred basis.

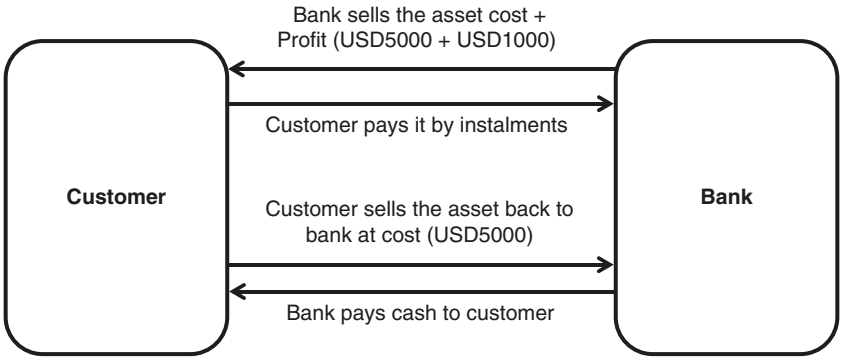

Fig. 5.9 The *inah*' personal financing modus operandi

4.2 Tawarruq *Personal Financing*

Tawarruq can be defined as an arrangement that involves the purchase of an asset based on *musawamah* or *murabahah* and the subsequent sale of the same asset to a third party in order to get cash money. For example, one party buys a commodity on credit term at a markup price and sells the same commodity at a lower price to a third party to get cash. The end result of this transaction is that, the customer obtaining cash to be used for his or her personal needs or business. Figure 5.10 depicted the *Tawarruq* personal financing modus operandi.

The *Tawarruq* personal financing modus operandi is as follows:

1. The customer and the bank (Islamic bank) enter into an arrangement where the customer promises to buy a commodity or asset from the bank. The customer at the same time appoints the bank as his agent to sell the said commodity or asset.
2. The bank buys a commodity or asset from broker A on a spot basis.
3. The bank sells the same commodity or asset to the customer on a deferred basis at cost plus profit.

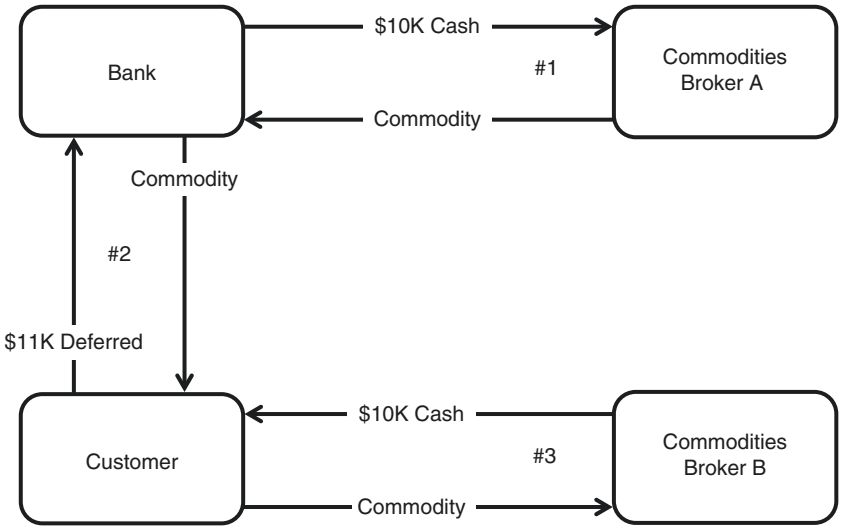

Fig. 5.10 The *Tawarruq* personal financing modus operandi

4. The bank as an agent to the customer sells the same commodity or asset to broker B on a spot basis.
5. The bank pays the customer, the sale proceeds in a lump sum basis.
6. The customer pays the bank the purchase price of the commodity or asset on a deferred installment basis.

4.3 Rahn *Personal Financing*

Rahn is defined as a pledge or collateral, whereby a valuable asset such as gold is given or pledge as security against an interest-free loan or financing. The Islamic bank only earns income from a fee (*Ujrah*) for safekeeping services (*wadi'ah*) provided on the valuable asset pledged by the customer. Figure 5.11 depicted the *Rahn* personal financing modus operandi.

The *Rahn* personal financing modus operandi:

1. The customer approaches the Islamic bank with a valuable item, such as gold, as collateral worth RM5,000 for financing.
2. The bank accepts the pledged asset (gold) and grants interest-free financing to the customer (e.g. RM4,000).
3. The customer pays a custodian fee for the service rendered in safe-keeping the asset (gold).
4. If the customer (debtor) is not able to repay the debt (e.g., 4,000), the pawned asset (gold) will be sold to settle the outstanding debt and any surplus will be returned back to the customer.

The computation mechanism of the *Rahn* personal financing is shown in Table 5.4.

4.4 The Main Critics of Personal Financing Products

For *Tawarruq* personal financing and *Inah* personal financing, it seems that both facilities are identical in terms of the purpose of getting immediate cash financing with a consideration of delay repayment plus some profit. Both facilities involve an exchange of assets/commodities to circumvent the *Shariah* ruling that prohibits interest-based loan facilities. The difference lies in the nature of commodity sold, where the *Inah* personal financing requires customers to buy an asset at original price plus profit with extended repayment period and sell back the same asset at original price to the bank. The *Inah* process

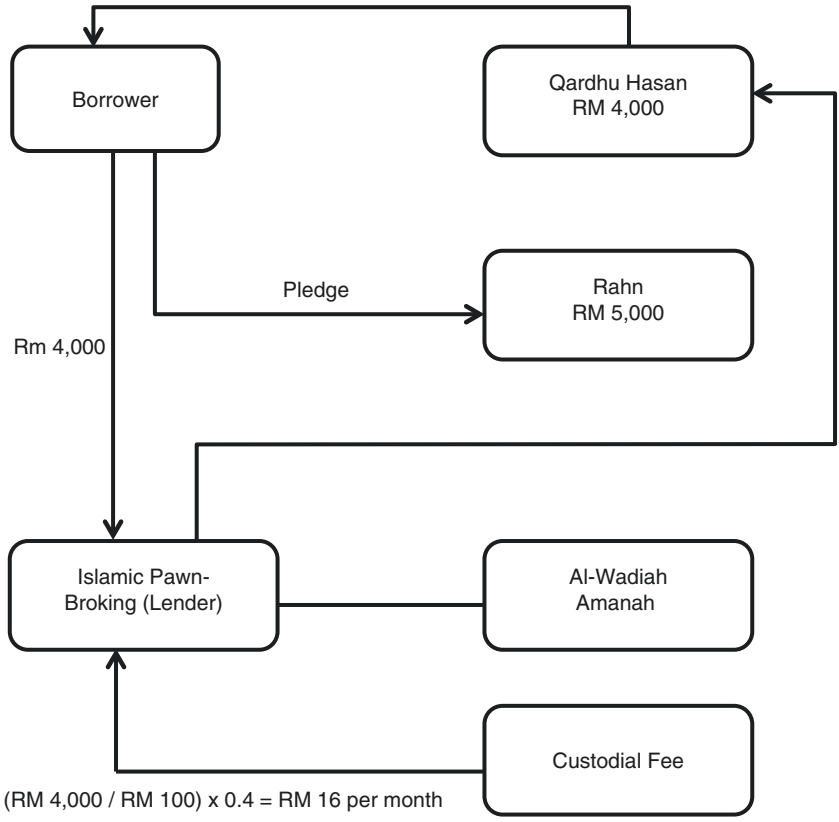

Fig. 5.11 The *Rahn* personal financing modus operandi

reflects the bilateral relationship between customer and bank. *Inah* facility has become controversial among Muslim scholars as the facility falls into unlawful credit sales because of its embodiment of the trick of *riba*.

On the other hand, *Tawarruq* personal financing involves buying and selling commodities with different parties. As mentioned in the previous section, the main issue pertaining to *Tawarruq* operation is the material ownership of the commodities both by the bank and customer since that the customer has only intention to get cash

Table 5.4 The computation mechanism of the *Rahn* personal financing

Formula	*Illustration*	
Monthly safekeeping fee for a month $= \frac{Gold\ value \times Rate}{100}$ The calculation of safekeeping fee is per month. If the customer pays the financing and redeems the Gold on the 5th month, than the safekeeping fee must be multiplied by 5.	Collateral Value (RM)	Fee (RM per month)
	Up to 500	0.60
	501–2,500	0.70
	More than 2,500	0.80
	Sample Calculation: Pledge Asset Value: RM10,000; Safekeeping Tenure: 6 months; Financing Amount (50%): RM5,000 $Total\ safekeeping\ fee = \frac{10,000 \times 0.8}{100} \times 6\$$ $= \text{RM}480$ *Note:* for the calculation, the amount is not financing amount, it is amount of GOLD value.	

financing and does not really bother to own the commodity. The same notion also applies to bank since the bank is not willing to bear the risk related to the ownership. Thus, according to Taqi Usmani (respected Muslim scholar), it is highly preferable for bank who knows that the buyer (*mutawwariq*) who is in need of cash liquidity for commercial purposes to offer a product that involves the contract of shirkah (partnership) or *mudharabah* (profit sharing) with the customer, as these two contracts are useful for financing and capitalization.

For *Rahn* personal financing, the facility gains increasingly popular choice of financing alternative to borrower and Islamic pawnbroking institutions. In a simple term, *Rahn* personal financing mirrors security contract whereby the customer is required to pledge his valuable asset as collateral for exchange in a deferred financing contract. Thus, this product is a form of combination of safekeeping contract (*Wadi'ah yad damanah*) and *Rahn* contract. However, this facility is not immune from receiving criticism from Islamic scholars. Several issues related to *Rahn* personal financing are the issue of the

safekeeping charge, the issue of combination of *Rahn* and *Wadi'ah* contract, the issue of guarantee (*yad Daman*) in *Wadi'ah* contract, among others (Abdul Khir et al. 2013).

Under the *Rahn* personal financing contract, the safekeeping charge (*Ujrah*) is connected to the value of the pledge asset that gains *Shariah* dispute. Through *Rahn* operation, the *qard* (loan) is only executed after the determination of storage fee is made where the customer needs to agree with the safekeeping charge. It seems that the safekeeping charge is relatively higher than the actual cost of storage by normal *Wadi'ah* operation by bank. It is argued that the inflated cost of safekeeping charge can reach up to the same value of original pledged asset value or part of it. This inflated safekeeping cost seems to be a legal trick (*hilah*) to bypass the *Shariah* prohibition on a *ribawi* based loan. The second issue relates to combination of *Rahn* contract and *Wadi'ah* contract on the same subject matter. From *Shariah* perspective, it is impermissible to combine two different contracts in a single contract as each contract entails different legal consequences and may not be harmonious. For instance, under the *Wadi'ah* contract, the pledged asset must be returned back to customer by guardian (bank) as per requested since the contract is a non-binding contract. The main role of the *Wadi'ah* contract is only to safeguard the safety of the *marhun*. In contrast, the *Rahn* contract rules that the pledged asset (*marhun*) will be returned back in condition that the pledger (*rahin*) has fully settled his debt commitment. This is true as *marhun* is used as a security for bank and at the same time increases the chance for customer to secure the financing. This ruling of *Rahn* violates the essential feature of *Wadi'ah* of returning pledged asset unconditionally.

For the issue of guarantee custody (*yad daman*) under the *Wadi'ah yad daman*, the issue concerns the changing the original feature of *Wadi'ah* that emphasis on trust-safekeeping to guarantee-safekeeping (Abdul Khir et al. 2013). The trust or *Amanah* safekeeping states that the custodian is not liable in the event of loss or damage of the pledged asset when the fault is not due to negligence by the custodian. However, under *Rahn* personal financing, the bank needs to provide guarantee to return the *marhun* when the customer has finally fulfilled his debt obligation. However, based on the majority of Hanafi scholars, the status of guarantee-safekeeping is automatically granted whenever a fee is imposed for the safekeeping.

5 Islamic Credit Card

Islamic banks credit card facility is another important and popular segment of Islamic retail financing. The most popular structures of Islamic credit cards are *Ujrah*-based and *Tawarruq*-based credit cards.

5.1 Ujrah *Credit Card*

Figure 5.12 depicted the *Ujrah* credit card modus operandi.

1. The bank provides a credit card account by providing *Qard Hasan* based on the cardholder's credit worthiness.
2. The cardholder pays the merchants for the goods from a credit card account.

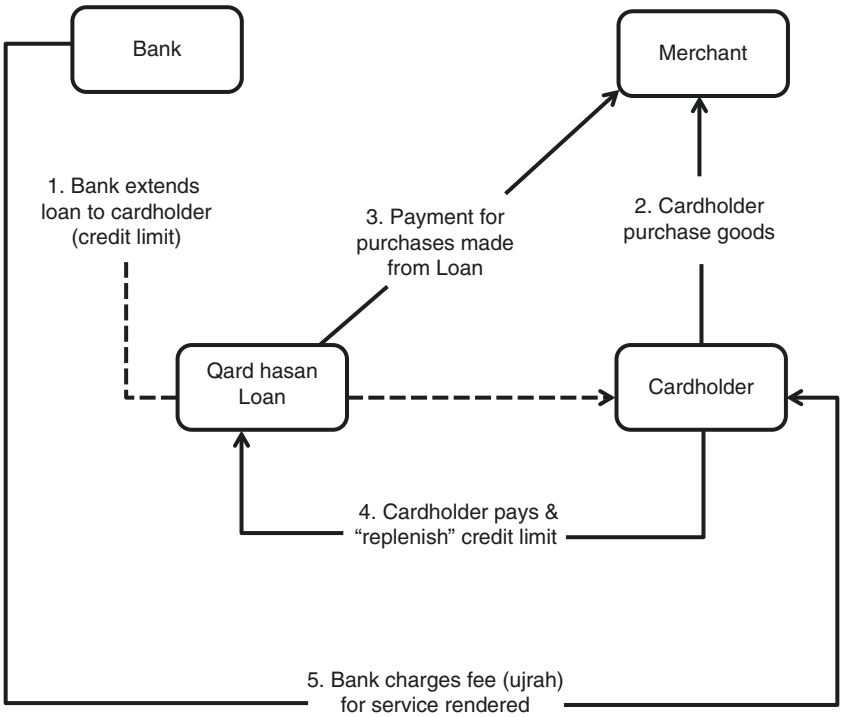

Fig. 5.12 The *Ujrah* credit card modus operandi

3. The bank provides *qard* (loan) to the cardholder for the purchased goods.
4. The cardholder pays the purchase amount and replenishes the credit limit.
5. The cardholder will be charged a fixed fee structure or other structures such as monthly service fee which is based on the actual cost of managing the transaction and an annual service fee based on the benefit rendered by the bank. The bank earns profit from the service fee and also commission from the merchant, if any.

5.2 Tawarruq *Credit Card*

Figure 5.13 depicted the *Tawarruq* credit card modus operandi.

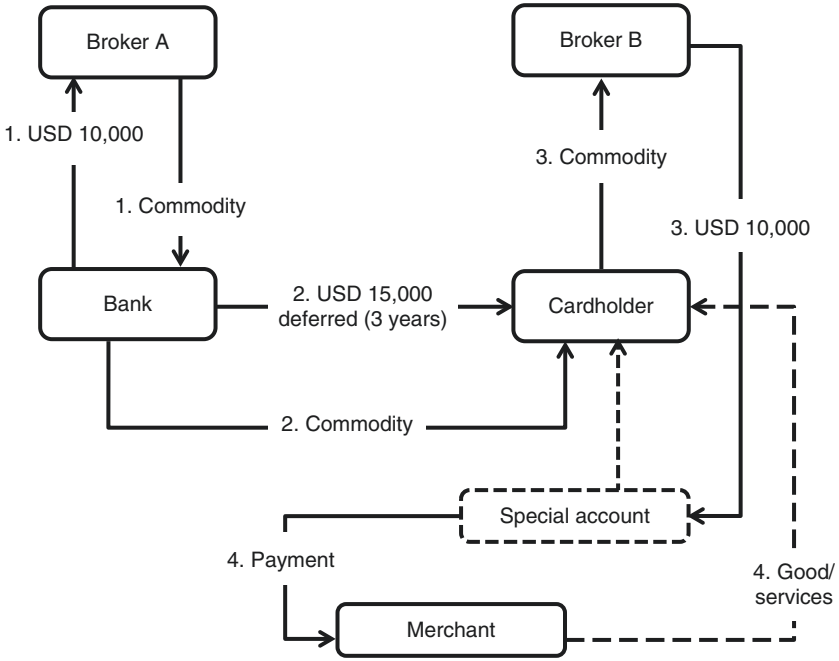

Fig. 5.13 The *Tawarruq* credit card modus operandi

The *Tawarruq* credit card modus operandi is as follows:

1. The bank purchases the commodity from broker A.
2. The bank sells the commodity to the cardholder for deferred payment for a price equivalent to its credit limit plus profit.
3. The cardholder sells the commodity to broker B.
4. Broker B deposits the cash into the cardholder's *wadi'ah* account (special account).
5. The cardholder buys the goods from the merchants using the *wadi'ah* account.
6. The purchase price is transferred to the merchants.

5.3 The Main Critics on Islamic Credit Card Facilities

To date, there are two types of credit card offered in retail market, which are the conventional and Islamic credit card. The former basically has interest element in repayment and has no restrictions in terms of buying goods and services while the latter needs to strictly follow *Shariah* injunction that forbids the purchase of *haram* (illegal) items such as pork, wines, and illegal activities such as gambling, prostitutions, and alcohol consumption. Furthermore, there is no element of interest payment for Islamic credit card as it subscribes profit rate instead of interest rate and follows permissible *Shariah* concepts such as *Ujrah* and *Tawarruq* (Amin 2012).

In the *Ujrah*-based credit card, the bank provides Qard-Hassan (benevolent loan) to a customer who requests immediate direct payment to the shop where the bank earns income through *Ujrah* (fee) for the service rendered. As the *Ujrah*-based credit card does not involve the commodity market, the operation is quite straightforward. The loan that does not contain any elements of *riba* is extended for the convenience of the customer.

The *Tawarruq*-based credit card uses the same concept to that of home *Tawarruq* financing and *Tawarruq* personal financing. A person who is willing to get some cash without immediate payment will use the credit card where bank purchases commodity from broker A in the open market and sell the commodity to customer with deferred repayment. To get the requested cash, the customer will sell back the commodity to broker B. From *Shariah* point of view, the transaction is not valid if the bank has not taken possession of the commodity, and the sale and purchase are interdependent. Thus, the ownership of the

commodity by bank must be taken in place to secure the validity of the credit card *Tawarruq* transaction from *Shariah* perspective. However, if the bank appoints an agent to buy the commodity and once the bank owns the commodity, the bank sells back to the same agent in separate contract; the transaction is allowed but not recommended (Ayub 2007). In addition, *Tawarruq* is carried out through massive international commodity exchange that involves the same brokers doing routine agency services, where there is potential of the absence of ownership transfer from buyer and seller that increases the vulnerability of *Shariah* ruling.

The identical issue relating to both the *Ujrah* credit card and *Tawarruq* credit card is the permissibility of a compensation charge for late payment (*Ta'widh*) of 1 % which reflects the actual cost incurred to the bank due to the delayed repayment. On top of that, Islamic Financial Institutions (IFIs) are allowed to impose fine or penalty (*Gharamah*) for late payment. Under the regular credit card repayment calculation, the formula will involve late payment interest of 18 % p.a. (1.5 % per month) that is commonly used by most banks in Malaysia. The *Shariah* ruling has allowed IFIs to charge penalties for defaulters and late payment as agreed upon by both parties aiming to discipline the customer. The *Shariah* ruling has imposed a condition that the penalty cannot be used for business undertaking or as a source of income but must be set aside for charitable purposes. It is advisable for the creditor to further extend the period of payment to lessen the burden borne by customer.

In the current scenario, the wide availability of credit card has increased motivation for spending on products and services that are basically not part of actual needs. These unplanned purchases might not have been possible using actual cash in hand. It is the norm that a rise in credit card spending incurs a consequential increase in excessive compulsive buying and consumers' indebtedness across all strata of Malaysian society. In terms of credit card default, the Malaysia Department of Insolvency announced that there were 4,875 users that had been declared bankruptcy due to outstanding credit card in 2013, where most of them were young males. In more recent records, Bank Negara Malaysia reports that the total balance of overdue credit card payment in 2014 was RM32.84 billion. In terms of repayment period, it seems that the short-term default outperformed the long-term default. In fact, there was declining trend for long-term credit card debt for a

period of more than 6 months from RM63.8 million to around RM7.2 million. Relatively, short-term debt (< 3 months) exhibits, climbing trend from RM1.9 billion in 2007 to RM2.4 billion in 2014. This phenomenon suggests that the short-term debt is much more prevalent due to heavy interest penalties for longer settlement.

6 Conclusions

From the above examinations, we can see that Islamic banks today seem to be more concerned about sticking to the word rather than the spirit of Islamic finance. We can explain this issue from several perspectives such as (i) form and substances, (ii) *Maqasid of Shariah*, (iii) over focusing on debt financing rather than equity financing, and (iv) wealth distribution.

Form over substance argument where the legal form is considered fully valid, but the substance is totally different. In the context of Islamic finance, some product and services in Islamic banking are valid from a legal perspective; however, their practices are similar to conventional banking in terms of pricing, interest-based benchmarks, the treatment of late payment, etc.

Maqasid of Shariah: a selling point of Islamic finance is that profit maximization should not be the only objective of financial institutions and that offering social value should be a part of the value proposition.

Over-focusing on debt financing rather than equity financing: with debt-based modes of finance used predominantly in Islamic finance and priced with same interest-based benchmarks, it seems that the practices of Islamic banking is far from the ideals of Islamic economic principles. It supposed to be intended to be *mudaraba* (or investment management) based equity financing, whereas in practice it is largely *murabaha* (or sale at a disclosed profit) based debt financing.

Islamic banks over focus on debt-based products and services such as *Murabahah*, BBA, *Tawarruq, Ijarah,* whereas the equity-based financings such as *Mudarabah and Musharakah* are less popular. The heart of Islamic finance—risk sharing—does not prevail in the practices Islamic banks. If Islamic banks rely too much on the debt-based contracts, the general public may become disenchanted with Islamic finance. Therefore, the Islamic banks should shy away from over-usage of debt-based financing, and should move toward more equity-based products and service.

The Islamic finance paradigm always has to consider values such as social well-being, *Maqasid* of *Shariah* to be central to any economic decision-making. It should emphasize equity along with efficiency in the allocation of resources and distribution of income, for example, zakat. Therefore, it is important that the Islamic banks not only try to maximize their own welfare, but also to take care of the different levels of the society by means of proper wealth distribution tools.

Notes

1. The customers are not currently related to any staff of the bank either as spouse, child, or parent. If the said relationship is established or discovered at any time, the customer needs to advise the bank immediately.
2. Akin to penalty interest in conventional bank
3. The SAC of BNM in its 95th meeting held on 28 January 2010 had stated that '*ta'wīḍ* (compensation) may be imposed on late payment of financial obligation arising from exchange contract such as sale sand ijarah'.
4. The SAC of BNM in its 24th meeting held on 24 April 2002 resolved that "Islamic banking institution may incorporate the clause on undertaking to provide *ibra*' to customer who make early settlement," Abdul Aziz (2013).
5. The *ibra*' practice was approved by Shariah Advisory Council in its 24th meeting on April 24, 2002 / 11th Safar 1423.
6. FAS 10 AAOIFI 2008, p. 325.
7. Article 390, The Mejelle, p. 57.
8. Para 4/1/1 FAS 10 AAOIFI 2008, p. 326.
9. Ibid, Para 4/1/3(a), p/ 327.
10. Para 4/1/3(c) FAS 10 AAOIFI 2008, p. 327.
11. (Mansuri, 2006).
12. Para 4/1/3(c), FAS 10 AAOIFI 2008, p. 327.
13. Para 10(a) FAS 10 AAOIFI 2008, p. 329.
14. Ibid, Para 10(b), p. 329.
15. Ibid, Para 10(c), p. 330.

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CHAPTER 6

Islamic Finance Insolvencies under Secular Bankruptcy Laws: A Case Study of Arcapita Bank under US Chapter 11

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Abstract Like many other financial institutions, Bahrain-based Arcapita Bank operating in the United States was hit hard by the Eurozone crisis that followed the global financial crisis. Unable to restructure its $1.1 billion debt obligations due in March 2013, the bank decided to file for Chapter 11 protection in the US Bankruptcy Court. This case study introduces Arcapita and its operations, explains the US Chapter 11 and its important aspects like debtor in possession (DIP) financing, highlights the most significant episodes of the Arcapita case, and concludes with important lessons embedded in the proceedings. The case as a precedent as well as Chapter 11 as the basis for a corporate insolvency law in Islamic finance is also discussed.

Keywords Insolvency · Chapter 11 · DIP financing · Shariah compliance

1 Introduction

Among major legal challenges confronting the Islamic finance industry is the treatment of insolvency and bankruptcy[1] that takes place in Islamic finance, which is then brought under a secular court. This is exactly what happened in the insolvency case of Arcapita Bank, which sought to file for Chapter 11 protection in the United States. The case is very interesting and it offers some excellent lessons for the Islamic finance industry with respect to insolvency treatment under Chapter 11. The move by Arcapita to file for bankruptcy in itself was interesting. Based in the Gulf, where most insolvency cases are decided through out of court negotiations and time extensions, it was an unusual step as stated by McCarthy and Kahn (2013): "many restructuring in the Gulf region are often negotiated out of court largely because formal restructuring in most countries in the region remains both costly and unpredictable." (pp. 10–11) It was the first ever incident of its type in which a Shariah compliant facility, i.e. the *murabaha* facility that was a part of Arcapita's reorganization plan, was brought in front of the US Bankruptcy Court for approval. Also, the case has raised a debate among practitioners as to whether it can be a precedent for future Islamic finance insolvency cases in the United States or not. These and many other important aspects and lessons of the case are a basic motivation for this chapter.

This case study is divided into a few sections. In Sect. 2, the background of Arcapita Bank is provided, followed by Sect. 3 that elaborates the bankruptcy laws of the United States. This is followed by Sect. 4 that details the case proceedings. Section 5 discusses the case as a potential precedent for future

cases, while Sect. 6 briefly addresses the question of whether Chapter 11 can be taken as the possible starting point for developing corporate insolvency law in Islamic finance. Section 7 concludes the case study.

2 Background of Arcapita

Arcapita is registered in Bahrain as a closed joint stock company and regulated under an Islamic wholesale banking license. The license was issued by the Central Bank of Bahrain that is responsible for maintaining monetary and financial stability in the country (Wiener and McGrath 2012). Arcapita Group is a leading global manager of alternative investments in a Shariah compliant manner and it operated as an investment and asset manager as well as an investment bank.[2] Its principal business activities include investment and providing investment opportunities to third-party investors, according to the rules of Shariah (Sprayregen et al. 2014). Arcapita invests and helps its clients invest in infrastructure, real estate, venture capital, and private equity (Chutchian 2013). Over its history, it has made substantial assets and investments across the United States and Europe including US storage company Pod, clothier J. Jill, a Northern Irish Utility Company and Houston-based Falcon Gas Storage Company (Raghu et al. 2013). Although established under Bahrain law, the subsidiaries of Arcapita are operating in the Cayman Islands, Luxembourg, Hong Kong, Singapore, the United Kingdom, and the United States (Sprayregen et al. 2014). Currently, it operates from the following offices across the globe:

- Manama, Bahrain: Covering the Gulf Cooperation Council (GCC) region and India;
- Atlanta, United States: Covering United States;
- London, United Kingdom: Covering the United Kingdom and Western, Central, and Eastern Europe; and
- Singapore: Covering Southeast Asia, China, Japan, and Australia (Arcapita Annual Report 2014: 5)

According to its 2014 annual report, Arcapita was formed for the following objectives:

- Provide investors with opportunities in alternative investment products in a Shari'ah-compliant manner and investment management services in connection with such products;

- Co-invest with its investors in Arcapita-sponsored investment products to generate a return on such investments; and
- Provide investment management and administration services (p. 10).

In addition, the firm provides services to over 1,300 customers across the GCC and Southeast Asia. There are four primary investor groups to which its customers belong:

- HNWI: High net worth individuals with investable assets in excess of $1 million;
- Family offices: Professional entities set up to manage the investments, business affairs, and philanthropic interests of high net worth families;
- Institutions: Large, sophisticated investment groups that include pension funds, university endowments, asset managers, and insurance companies; and
- SWFs: State-owned investment funds (Arcapita Annual Report 2014: 10)

3 The United States Bankruptcy Law

3.1 An Overview of Chapter 11

In US bankruptcy law, there are two solutions to the problem of debt overhang for corporations; the first is liquidation under Chapter 7, while the second is reorganization under Chapter 11. Chapter 11 usually commences with the filing of a petition by debtor voluntarily with the court. The petition includes summary of the assets and liabilities as well as a list of creditors. An important requirement for the application is the existence of "good faith" and the objective is to reorganize the company mostly. If the creditors feel that the filing is done in bad faith, they may request the court for dismissal of the debtor's petition. Alternatively, they can file their own petition for involuntary proceedings with certain conditions. Upon filing of the petition, the debtor automatically assumes the status of "debtor in possession" (DIP) which refers to "a debtor that keeps possession and control of its assets while undergoing reorganization under Chapter 11, without the appointment of a case trustee" (Farmida 2013: 30). Also, a moratorium or automatic stay takes effect upon filing of the petition which provides a period of time.

> In which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition. A party who takes any action in violation of the automatic stay risks contempt of court actions and penalties. (Farmida 2013, p. 30)

However, the stay can be lifted by the court upon or without the request of creditor(s). But the courts are "generally reluctant to do so during the initial stages of a Chapter 11 case because of the general presumption that a debtor should be given a chance to reorganize and prepare a reorganization plan." (Farmida 2013, p. 30)

The reorganization plan is the most important episode of Chapter 11 filing. It is a plan that is approved by the court and which provides the details of the debtor's plan to reorganize. The debtor has 120 days called "Exclusivity Period," likely to be extended to a maximum of 18 months, effective from the date of Chapter 11 order during which he needs to seek the creditor's acceptance of the reorganization plan known as "soliciting acceptances" within 180 days from the date of Chapter 11 order. However, a disclosure statement, approved by the court, is required before seeking the acceptance of creditors which should contain all details about assets, liabilities and business affairs of the debtor so that the creditors can make an informed decision about the reorganization plan of the debtor. The reorganization plan must contain the classification of claims and how each class of claims will be treated. Creditors are put in classes under Chapter 11 who have the right to vote in favor of the reorganization plan "by a majority in number and two-thirds in amount of those actually voting" (Farmida 2013, p. 31). The minority is bounded by majority vote on the condition that the plan voted for provides to each creditor at least what it would have received in the case of liquidation. This is known as the best interest test. Once the Exclusivity Period is over and the debtor is unable to file a plan or to get it approved by creditors, an individual creditor or "creditors' committee" can propose their own plan of reorganization. The creditors' committee is appointed by the US Trustee and usually consists of unsecured creditors holding the seven largest unsecured claims against debtor. This committee plays a very important role in Chapter 11 cases as it "consults with the DIP on the administration of the case, investigates the debtor's conduct and operation of the business, and participates in formulating a reorganization plan." (Farmida 2013, p. 31) Most likely, the reorganization plan will consist of one or more of the following:

- an infusion of new equity from existing holders or from third-party investors;
- new cash funding from third-party lenders;
- new debt issued to creditors to replace, or partly pay their existing debt;
- a debt for equity swap;
- a sale of the non-core aspects of the debtor's business; or
- a sale of all or substantially all of the debtor's assets and a distribution of the proceeds to creditors. (Farmida 2013: 31)

If the court is satisfied with the reorganization plan, it confirms it and the Chapter 11 proceedings conclude. Confirmation may also be given even if the voting threshold has not been achieved on the condition that "the plan does not 'discriminate unfairly' and is 'fair and equitable' with respect to the dissenting class. In other words, the court can, in appropriate circumstances, force creditors to accept a plan (known as a cram down)." (Farmida 2013: 32). Once confirmed, the plan is binding upon all creditors. The property revests in debtor who is now clear of all pre-petition claims. He is also bound by the provisions of the reorganization plan and new contractual rights are created now, which replace or supersede the pre-bankruptcy contracts.

3.2 Debtor in Possession (DIP) Financing

A key characteristic of Chapter 11 is DIP financing, commonly known as DIP financing, DIP facility or DIP loan. DIP financing enables firms the issuance of senior secured claims that are given priority over other creditors (Ayotte and Skeel 2009). The mechanism of DIP financing has been summarized by McMillen (2012) in these words:

> In bankruptcy, insolvency and distressed debt transactions in the United States (and other jurisdictions that allow or encourage the financing of debtors), DIP Financings have assumed a particularly important role. DIP Financings are post-petition loans to the debtor in the bankruptcy proceeding. Under the United States bankruptcy laws, the DIP Financing receives the benefit of a 'super-priority' claim and is paid before other priority claims. In some circumstances, with the consent of the court and with certain qualifications, lenders that made pre-petition loans will make, or participate in the making of, the DIP Financings and will consolidate their pre-petition loans with the DIP Financings. This consolidation has the effect of trumping pre-petition secured creditors and bootstrapping the pre-petition position of the DIP Lender. (p. 18)

The super-priority status of the DIP lender over the assets of a debtor's assets is what distinguishes DIP loan from standard loan. The only exposure of DIP loan is against the administrative or "burial expenses" in case the reorganization does not succeed and the firm subsequently files for liquidation under Chapter 7. But different clauses of the US bankruptcy code provide security to DIP over other claims like administrative expenses and claims, a junior lien on encumbered assets and a lien on unencumbered assets. However, the highest level of security is provided by section 364(d) which allows a senior or equal lien on the assets that are already subject to a lien (Dahiya, John et al. 2003). In addition, the DIP lender receives higher part of the return of its new investment. Although there can be secured loans available outside bankruptcy, there might be restriction to avail them. For example, the majority of the bond indentures carry a negative pledge clause which prevents or restricts the occurrence of new senior debt. This is where filing for bankruptcy becomes handy and whereby such clauses are rendered ineffective (Ayotte and Skeel 2009). DIP financing is a very important component of a successful reorganization process of a company opting for Chapter 11. Studies have found that DIP financing is common in those cases that involve larger firms and are "prepackaged" in nature. "A prepackaged case is one in which the debtor secured approval for its Chapter 11 plan, from a super-majority of creditors, *before* the firm actually filed its Chapter 11 petition" (Ayotte and Morrison 2009, p. 5). Furthermore, DIP financing can come in two forms: "a DIP loan provided by the existing secured lenders is referred to as a *defensive* DIP while a loan from a new third party lender is called an *offensive* or *new money* DIP" (Huebner 2005, p. 30). After reorganization, the corporations usually retain most or all their assets and are controlled by their pre-bankruptcy managers.

4 Arcapita in Financial Distress

4.1 Filing for Chapter 11 Protection

Just like other financial institutions that were tested in the wake of global financial crisis, Arcapita confronted serious financial problems in the beginning of year 2012. In particular, the debt crisis in Eurozone limited its ability to refinance a syndicated facility worth $1.1 billion that was due to mature on 28 March 2012 (Griffiths 2013, p. 2). The global financial crisis and dislocation of the European capital markets hampered the firm's

ability to borrow for serving its debt obligations. It stated in one of its filings in the court that: "Like virtually all investment banks and private equity institutions, the Arcapita Group has been adversely impacted by the global economic downturn, and has been especially hard hit by the recent debt crisis in the Eurozone" (Hornbeck 2012). In order to cope with this situation, Arcapita tried to engage with its creditors in outside the court negotiations to find a solution through a consensual restructuring plan that is acceptable to all its stakeholders (Sprayregen et al. 2014: 18).

As its plan A, Arcapita tried to reach a consensual restructuring with its creditors via a 3-year extension of the $1.1 billion debt. The decision to go for restructuring was made due to the unwillingness of banks to help during the crisis period. Consequently, Arcapita had to look for alternatives, including initiating restructuring proceedings in Cayman Island, which was home to one of its subsidies that had a significant share in Arcapita's balance sheet investment. But the process could not go smooth as expected and problems were encountered. One of the hedge funds wanted to be bought out at par failing which it threatened to file liquidation proceedings against Arcapita. But such proceedings would have proved destructive for Arcapita. Consequently, Arcapita decided to file for Chapter 11 in New York. Although it was a Bahrain-based company, it was eligible for this filing because it operated in the United States through Arcapita Inc., which was a holding company incorporated in Delaware and had offices in Atlanta. However, it was required to prepare for the filing on an urgent basis; first, it was asked to get ready to file within 3–4 weeks, but few days later it was called to get prepared within just 3–4 days (Johnson 2014).

As its plan B, Arcapita filed for bankruptcy protection in the US Southern District of New York after its Board of Directors authorized such filing on 18 March 2012 (Wiener and McGrath 2012) in order "to protect their business and assets, and implement a comprehensive restructuring". The next day, Arcapita with five of its affiliate entities sought Chapter 11 protection in the Manhattan Bankruptcy Court. By the time of its Chapter 11 filing, Arcapita had $7 billion in assets under management and 268 employees (Karry and Sharif 2012). However, the action was said to be taken without proper preparation and the filing was seen as unplanned. But this was attributed to "insufficient time to develop a business plan, finalize valuations of the underlying portfolio assets, or determine claims treatments in a chapter 11 plan" (Wiener and McGrath 2012, p. 2). The situation is understandable since bankruptcy filing is a form of emergency situation in most cases.

4.2 The Unique Nature of Arcapita's Filing

The bankruptcy filing by Arcapita was unique in many ways. First, it is difficult for the Western courts to address matters related to Islamic law. This is attributed to the nature of Islamic law which is not codified. Consequently, Islamic law is found extremely difficult by the Western courts to deal with (Johnson, 2014). But in spite of this, Arcapita decided to file in a secular court which was an unexpected decision. Second, since Arcapita was a Gulf-based company, this action was seen with curiosity by many because it was against the customary practices in the Gulf: "The move was unprecedented in a region where most debt workouts have involved consensual talks that ended in long maturity extensions" (Hals 2013). This is also asserted by Anita (2012) who maintains that this move was a deviation from the normal Gulf standards where most of refinancing since 2009 have been resolved privately. In fact the strategy in the UAE is that of "amend and extend" under which a distressed company amends its credit agreements in order to avoid default by extending the maturities of debts. The creditors also hope that they would be able to receive their debts through extension (Johnson 2014). Thus, Arcapita's filing was a unique decision due to its deviation from the standard norm.

Although Arcapita was based in and regulated by laws in Bahrain, it had no opportunity to pursue a workable restructuring plan under the laws of Bahrain. This is due to the absence of an effective insolvency law in Bahrain (Sprayregen et al. 2014). Even the overall bankruptcy laws in the GCC countries are primarily liquidation laws and are unable to offer a restructuring mechanism for troubled companies. As a result of problems faced by the region during the global financial crisis, many governments are pondering over policy and legal reforms to effectively handle such situations in the future (Raghu et al. 2013). How far back the region is in terms of an effective insolvency regime can be deduced from the fact that according to a survey by the World Bank, "on average, an insolvency proceeding in the Middle East-North Africa region takes almost twice as long, costs over 50 percent more, and returns less than half in creditor recoveries in comparison to the average for OECD countries" (Sprayregen et al. 2014, p. 19). There is a social stigma associated with bankruptcy in the GCC region, which makes filing for bankruptcy protection, something unheard of in the region. Coupled with this stigma, the inadequacy of the outdated bankruptcy laws in the region was highlighted in the aftermath of the global financial crisis when many firms in the region were caught amid the issues of

insolvency and debt default without sufficient legal ways for resolutions of such problems. As a response, different legislations were put together hastily to combat this situation, including Decree 57 in Dubai and Financial Stability Law in Kuwait (Raghu et al. 2013).

Other researchers observed Arcapita to be an interesting case because of the Shariah compliant nature of its business: "Arcapita is an unusual debtor because it manages billions of dollars and it is committed to conducting itself in all respects in a manner that comports with the exacting ethical standards of Shariah law" (Wiener and McGrath 2012, p. 1). Coupled with its origin and the nature of its business was the fact that Arcapita applied for something that entailed debtor-in-possession financing, something that is well known to the US Courts but is totally unique in Islamic finance: Arcapita was the first ever Gulf-based as well as the first ever Shariah compliant entity which filed for Chapter 11 bankruptcy protection. During the process, the first Shariah compliant debtor-in possession financing was created (Johnson, 2014). At the time of filing for Chapter 11 protection, the Central Bank of Bahrain was listed as Arcapita's largest creditor with a $255.1 million claim, followed by Commerzbank AG and National Bank of Bahrain with claims of $164.7 million and $132.3 million respectively. The Central Bank of Bahrain stated that it was closely monitoring the case probably because it was the authority that issued license to Arcapita. On the first day of its pleadings, Arcapita requested the bankruptcy court to issue an order that restricts the foreign creditors from seizing its assets. The coordinating committee of lenders that engaged in negotiating the terms of restructuring plan was chaired by Royal Bank of Scotland Plc (Karry and Sharif 2012). And the final restructuring plan itself was to be filed by December 2012 and put before the bankruptcy court for approval by the first quarter of 2013. Otherwise, Arcapita would lose control of its bankruptcy case which will allow other parties to file their own restructuring plans (Checkler 2012).

4.3 Arcapita and DIP Financing: The Fortress Facility

When Arcapita commenced its Chapter 11 case, it had approximately $120.1 million in available cash. But a major portion of it was exhausted in funding the existing deals that Arcapita had invested in, in order to preserve the going concern value of Arcapita. Consequently, it needed to raise further funds in order to complete its restructuring process successfully. Being a Shariah compliant entity, Arcapita sought $150 million of

Shariah complaint DIP financing from Silver Point. A Greenwich, Connecticut-based hedge fund specializing in distressed companies' investment, Silver Point negotiated with Arcapita to issue a commitment letter to the latter for the provision of *murabaha* facility. Initially, the Silver Point DIP was structured as an initial $125 million multi-draw term facility to which an additional $25 million could be added. Of this whole facility, $25 million was sought on an interim basis while the remaining would be subject to the entry of a final order by the bankruptcy court (Griffiths 2013). However, concerns were raised about the Silver Point facility by several parties including a bankruptcy judge. The first concern was the inclusion of a charge according to which Silver Point could get out of the loan very easily. In addition, the fee charged by Silver Point was also high (Checkler 2012). Thus, the Silver Point DIP deal could not be concluded and Arcapita had to look for other alternatives.

Arcapita finally decided to avail a *murabaha* financing package from an investment management firm Fortress Credit Corp. based in New York. The package offered by Fortress was $150 million consisting of an initial $100 million multi-draw term facility followed by $50 million delayed draw term facility, conditional upon additional due diligence to be performed by Fortress. The facility included a 3% upfront fee that was reduced by a $2 million commitment fee. In addition, the "Outstanding obligations under the *Murabaha* DIP facility accrued profit at a rate equal to 1-month LIBOR plus a 10% margin per annum on the unpaid principal amount of the facility" (Griffiths 2013, p. 3). The underlying assets used in *murabaha* facility were London Metal Exchange metals. According to the structure of *murabaha* contract, Arcapita (the borrower) would appoint Fortress (the lender) as its agent to buy such commodities worth the financing amount plus upfront profit as agreed upon by the two parties on deferred basis. Later, Fortress would sell these on cash basis to a third party and provide the cash price to Arcapita. The end result is that Arcapita would receive immediate cash and would be obliged to pay Fortress a higher amount on deferred basis. Arcapita concluded the deal with Fortress in December 2012 that was approved by the New York Court after no objections were filed by any of the creditors. It is noteworthy that DIP financing is a regular feature of US bankruptcy proceedings. They are well known to and require the approval of the bankruptcy courts. The procedure of DIP facility is fairly standardized. Furthermore, these credit facilities "are granted super-priority status in distributions from the debtor's estate and are used to finance the company's bankruptcy proceedings, restructuring and/or

liquidation efforts, and activities taken upon its exit from bankruptcy." (McCarthy and Kahn 2013, p. 11)

4.4 Arcapita and DIP Financing: The Goldman Sachs Facility Between Shariah and Chapter 11 Compliance

The Fortress DIP facility was due to mature in June 2013. However, Arcapita was unable to conclude its bankruptcy proceedings by that time. Furthermore, Arcapita planned to restructure itself into two entities. The first entity would liquidate its existing assets while the second would manage the liquidation process and then proceed to do new business once the company exits from bankruptcy. This situation forced it to arrange for another DIP facility. Accordingly, Arcapita had to select between a DIP facility provided by Fortress as before and that by Goldman Sachs. Since the facility offered by Goldman Sachs was more favorable, it was preferred over the Fortress facility due to its optimal terms. Additionally, it was also in the best interest of Arcapita's creditors and other stakeholders enabling the bank to implement its amended plan. According to the bank's statement, the Goldman Sachs facility had the potential to provide the debtor with immediate and ongoing access to cash proceeds of the DIP transaction which was aimed to repay the current obligations after the Fortress facility had matured and to fund the current operating expenses that included post-petition wages and salaries. The ongoing access to cash would also make the scheduled payments easy which was required in order to preserve the debtor's assets value (Bishop, 2013).

The Goldman Sachs facility was essential due to two reasons: first, it would furnish to make payment to Fortress on the maturity date of the DIP loan. Second, the bank would only have $900,000 left on 22 June as funds for its remaining Chapter 11 proceedings, far less indeed. Thus, Arcapita entered into a new DIP facility with Goldman Sachs International to replace the existing Fortress facility on 15 May. Pursuant to this new facility, Goldman Sachs would provide $150 million *murabaha* facility which would later convert into a larger $200 million *murabaha* exit facility. Just as the Fortress facility, the mechanism of Goldman Sachs facility was to provide funds to Arcapita through a series of commodities transactions. However, whereas there was no objection against the Fortress facility on Shariah grounds, the Goldman Sachs facility was questioned by a group of Arcapita creditors. This group asserted that the

Goldman Sachs facility should not be approved by the court because it was not in compliance with Shariah. The logic they presented for the non-compliance was that the proposed *murabaha* facility which consists of commodities transactions did not require physical transmission of the metals (which is a Shariah requirement for the validity of such transaction) and, thus, it is a disguised form of lending with interest that is prohibited under Shariah principles.

A hearing upon the objection was held by the court during which the Council for Arcapita argued that the Shariah Board of Arcapita already had the Goldman Sachs facility and "the Court itself did not need to determine whether or not the Goldman Sachs facility was in fact Shari'a-compliant in order to approve of the transaction as a matter of U.S. bankruptcy law" (McCarthy and Kahn, 2013, p. 12) Since the Goldman Sachs facility had been approved by the Shariah Board of Arcapita, this approval was both correct and sufficient to satisfy the terms of the facility. The Court only needed to determine whether the facility was in the interest of all the parties involved. The Court's attention was also drawn to the holding of the UK Court of Appeal in *Beximco Pharmaceuticals Ltd. v. Shamil Bank of Bahrain E.C.* whereby the Court had found that the *murabaha* agreement is enforceable as a matter of UK contract law, without any heed to the question of Shariah compliance or otherwise of the facility. In response to this, the Council for the objectors acknowledged that it was not the province of the bankruptcy court to determine the compliance or non-compliance of the facility with Shariah. However, the Court should still not approve the facility because of its being non-compliant with Shariah. Given this course of argument, it was unsurprising that the Court did not listen to the objectors and only focused on whether the facility is in accordance with the US federal bankruptcy law or not. Once it was confirmed, the facility was approved and Arcapita successfully entered into it (McCarthy and Kahn 2013).

4.5 Successful Reorganization

In June 2013, the bankruptcy court approved Arcapita's reorganization plan under which it would gradually liquidate its private-equity investments. The approval of the plan of reorganization was a sigh of relief for all the stakeholders of the case. The Chief Executive of Arcapita expressed his satisfaction about the reorganization process by stating that it was a challenging task to do but it provided a good framework to the company

to restructure itself for the benefit of the investors, creditors and all stakeholders. Arcapita's lawyer appreciated the support of all stakeholders which enabled the company conclude the deal: "Who would've guessed the immense level of support, not only from the bank's creditors but also its shareholders." Even the judge, Sean H. Lane of Manhattan's Bankruptcy Court found the case interesting. He appreciated the behavior of those involved in the case, saying that the settlement was very reasonable and the the whole process was a sensible way to settle a dispute which had many complicated aspects (Chutchian, 2014).

Three months later on September 17, the process of Arcapita's reorganization completed successfully. According to the plan of restructuring, the company will gradually dispose of its assets during the next 5 years. The plan was approved by 99 % of its more than 1200 creditors who held more than $2 billion in claims. It not only prevented fire sale, but also gave time to Arcapita's businesses to mature and liquidate its assets at a time that maximizes value. To facilitate the process of winding up, the bank will be split into two entities. The first entity was a new company called RA Holding Corp., which was owned by Arcapita's creditors and to which the existing assets of Arcapita were transferred. Realizing the value of Arcapita's portfolio, comprising of about 30 investments totaling $7.4 billion in asset under management, will be the main function of RA Holding. As the second entity, Arcapita will emerge reorganized and renamed as AIM Group Limited which will aim to raise money from the existing investors of the bank. AIM will also continue making investments in health, education and logistic sectors. AIM will be led by most of the senior managers of Arcapita remaining with AIM. From the proceeds of the sale, $530 million will initially be paid to Goldman Sachs for its provision of funding to Arcapita to continue its operations. Standard Chartered Bank, the only secured creditor was also paid its $100 million claims in full. The unsecured creditors who are owed $1.1 billion will recover an estimated 64% of their cash mainly through the issuance of a new $550 million Islamic bond by the bank. The sale process has already begun; Arcapita raised $740 million through the sale of Varel International Energy Services Inc. in January 2014 to Sandvik AB., a Swedish engineering group (Johnson 2014). Eventually, Arcapita successfully exited its bankruptcy status: "so the first use of Shari'a-compliant bankruptcy financing in U.S. Courts must be termed a success" (McCarthy and Kahn 2013, p. 13).

5 The Future of Islamic Finance Bankruptcies under US Chapter 11: Can Arcapita Become a Precedent?

The success story of Arcapita's restructuring in the US Bankruptcy Court has been viewed as a promising signal for the future of Islamic finance insolvencies taking place in the United States. As commented by Griffiths (2013, p. 4):

> As long as the proposed form of DIP financing is permissible under the Bankruptcy Code, a bankruptcy court may approve a Sharia-compliant financing structure. The ease with which the U.S. bankruptcy system is able to adapt to alternate forms of financing is a testament to its design and inherent flexibility.

The case is also viewed as a possible precedent and indication of how the U.S and Western courts will deal with Shariah contracts and disputes in the future (Johnson 2014). Furthermore, the behavior of the court whereby it refrained from issuing a judgment about the Shariah compliance status of the Goldman Sachs facility has been rightly appreciated by writers: "However, the Court quite rightly refrained from ruling upon the compliance or non-compliance of Arcapita's DIP financing with applicable principles of Shari'a law" (McCarthy and Kahn 2013, p. 13). The approval of Shariah compliant DIP facility by the US Bankruptcy Court shows the flexible nature of these courts that can adapt to alternative forms of financing: "As long as the proposed form of DIP financing is permissible under the Bankruptcy Code, a bankruptcy court may approve a Sharia-compliant financing structure. The ease with which the U.S. bankruptcy system is able to adapt to alternate forms of financing is a testament to its design and inherent flexibility" (Griffiths 2013, p. 4). Thus, cases such as Arcapita or East Cameron present some promising signs for future Islamic finance insolvencies in the United States: "Therefore, court decisions about the treatment of Islamic financial products in the coming years will substantially affect the growth of this lucrative industry in the United States" (Graham 2011, p. 328).

The successful episode of Arcapita under Chapter 11 also highlights somewhat of an ironical situation in contemporary Islamic finance industry. It draws attention to the fact that even secular courts may be more interested in and keen to apply Shariah principles of bankruptcy if they do

not clash with the laws of jurisdiction in question. On the other hand, insolvency and bankruptcy in Muslim dominated jurisdictions and courts are dealt purely under secular laws, even if they are in sharp contrast to Shariah. Consider, for instance, how Mallat (2011) has aptly commented on this ironical situation:

> I found it very interesting that British courts were asking very pointed questions about classical bankruptcy law in Islamic law, whereas it is dealt with in Saudi Arabia in a very different way. Thus we have a situation where Islamic law is more sought after in its classical dimension elsewhere than in the countries where it is supposed to be. (p. 4)

Interestingly, Arcapita is the second Islamic finance insolvency case brought to US Bankruptcy Court. In 2008, a *sukuk* issued by East Cameron Partner (ECP) went insolvent and the originator filed for Chapter 11 protection. During the course of hearing, the court ruled that the underlying asset of *sukuk* has been transferred to the *sukuk* holders. However, the case was finally solved outside the court due to many complexities faced by the *sukuk* holders as well as the originator. Hence, it can be said that Arcapita is the first ever example of Islamic finance insolvency that ended with a successful reorganization under US Chapter 11.

6 Can Chapter 11 be Adopted as the Corporate Insolvency Model for Shariah-compliant Entities?

The successful reorganization of Arcapita prompts one to inquire if Chapter 11 could be used as the foundation for developing a Shariah-compliant version of corporate insolvency law? A few points should be remembered here. First, there is no corporate insolvency law that exists in Shariah. This is because Islamic law was formulated centuries back and it only dealt with the insolvency of individuals and not corporate (since no corporate bodies existed by that time). Second, Islamic finance is currently working on an ad hoc basis. In other words, there is no pure Islamic law on which Islamic finance is founded. Instead, it is conventional laws that are molded for this purpose. Third, for adopting a conventional insolvency law for Islamic finance, the law must be scrutinized and judged in terms of its compliance or otherwise with Islamic law. Keeping these facts in mind, Chapter 11 or any other corporate insolvency law can be adopted as a model in Islamic finance provided that it does not contradict the tenets of

Shariah. This can be done by analyzing the founding principles as well as the practical pillars of the law in focus in the light of Islamic law and jurisprudence.

The foundation on which Chapter 11 is built is its debtor friendliness. The philosophy on which this law is modeled stems from the notion that every human being is an entrepreneur who should be given a second chance in the case of failure. This idea in itself is not opposed to Shariah. In fact, we find in the Quran a friendly attitude toward distressed debtors whereby it is commanded that a distressed debtor should be given respite till solvency. What is more interesting is the fact that a debtor is amongst the eight recipients of *zakat*, which shows the friendly attitude of Islam toward debtors. However, what differentiates Islamic law from Chapter 11 is the former's emphasis on debt repayment; the debt has to be paid at all costs and if its payment is avoided in this world through unfair means, the debtor will be held answerable for it in the afterworld. This is a sharp foundational difference between the two systems.

On the practical side, Chapter 11 has been subject to criticism due to its numerous limitations. Although a detailed analysis of these limitations is outside the scope of this research, a few weaknesses leading to severe criticism from conventional scholars should suffice to reveal the weaknesses of Chapter 11. The strongest criticism stems from the fact that Chapter 11 is too lenient toward all debtors and allows them unlimited powers in almost all matters without any restrictions. Thus, Eisenberg and Sundgren (1996) argue that "Chapter 11 is too easily available and that it allows debtors too much control by, inter alia, not requiring the appointment of a trustee" (p. 1533). This fact is also emphasized by LoPucki (1995) who asserts that not only is Chapter 11 too lenient toward debtors, its approach of "one size fits all" is also criticized by many researchers:

> In recent years, however, Chapter 11 has been the subject of a barrage of criticism from academics, the mass media, and parties to the cases.45 The principal complaint seems to be that one size does not fit all; the Chapter 11 procedure designed by big-case lawyers for big cases has produced an unreasonable delay and expense in ordinary Chapter 11 cases. It also can be seen, in retrospect, that Chapter 11 gave debtors more control than necessary or appropriate. (p. 580)

One important concern has been raised by LoPucki which he calls "forum-shopping.". Accordingly, the writer believes that Chapter 11 has corrupted

the US Bankruptcy Courts, which have started competing for large bankruptcy cases due to the lucrative benefits (in the form of high fees, etc.) that they offer. In their competition, different courts offer numerous incentives to large corporations to file in their jurisdiction/state. Thus, large corporation can go "shopping" with respect to their selection of a particular bankruptcy court and select among the "best offers". St James (2005) has summarized LoPucki's notion of forum-shopping in the following paragraph:

> LoPucki demonstrates that forum shopping has become a serious problem, distorting bankruptcy law as it is applied to the largest cases . . . In essence, LoPucki argues that the Delaware and Manhattan bankruptcy judges have offered prospective Chapter 11 cases a "deal," albeit a tacit and unstated one: "file in my court, and I will predictably rule in your favor and contrary to established bankruptcy law on several issues of critical importance to you." LoPucki then catalogs a number of issues as to which those courts predictably make rulings that differ markedly from the mainstream, arguing that this proves that the courts are corrupt. As a corollary, LoPucki argues that the "corrupt" courts are also failures at reorganizing companies, premised upon a statistical analysis of "recidivism" (Chapter 11 debtors who file a second bankruptcy case within five years after "successfully" completing their first bankruptcy case). (St James 2005, p. 172)

Further criticism comes from experts of the American Bankruptcy Institute who argue that Chapter 11 is outdated as well as expensive:

> Nevertheless, today's financial markets, credit and derivative products, and corporate structures are very different than those existing in 1978 when Congress enacted the Bankruptcy Code . . . Moreover, anecdotal evidence suggests that chapter 11 has become too expensive (particularly for small and medium-sized enterprises) and is no longer capable of achieving certain policy objectives such as stimulating economic growth, preserving jobs and tax bases at both the state and federal level, or helping to rehabilitate viable companies that cannot afford a chapter 11 reorganization. (American Bankruptcy Institute 2014, p. 12)

The above criticism deserves to be taken very seriously since it comes from bankruptcy professionals in the United States itself, which is the birthplace of Chapter 11.

To sum up, Chapter 11 does have the potential to be considered as a possible model for developing corporate insolvency law in Islamic finance. However, equal attention must be paid to the negative sides of it too. What appears from the above criticism is that it will need great efforts to mold Chapter 11 in order to make it Shariah-compliant. However, one cannot deny its potential for this purpose as evidenced from the successful reorganization of Arcapita.

7 Conclusion

Arcapita's filing under US Chapter 11 is an interesting case in many ways. The successful ending of the story of Arcapita is a major breakthrough because the bankruptcy laws in the Gulf region have not been tested so far. Taking Arcapita as a role model, it is expected that others will also follow its footsteps: "The West offers companies in the Middle East with the possibility of a court-supervised corporate rescue, and because nominal U.S. connections can provide a basis for a chapter 11 filing, we can expect that there will be more filings on Arcapita's heels" (Wiener and McGrath 2012, p. 2). Since US Bankruptcy Courts can be a viable forum for other Islamic financial institutions in distress where they will only need to prove their strong nexus with the United States: "Other Islamic institutions and businesses in distress with a U. S. nexus may in the future consider U.S. bankruptcy courts as appropriate forums for restructuring..." (Griffiths 2013, p. 4) Thus, Arcapita can be termed as the gate opener of Chapter 11 for Islamic as well as Middle Eastern based financial institutions that are in distress but have access to Chapter 11. However, the potential of Chapter 11 as a Shariah-compliant bankruptcy law model is a question that is not easy to be answered.

Notes

1. In spite of differences between the concepts of bankruptcy and insolvency, the two terms are used interchangeably in this chapter.
2. Arcapita was not a licensed bank or formal bank "branch" or "agency" within the meaning of the US Bankruptcy Code. Under (somewhat counterintuitive) US bankruptcy law, those qualifications could have made it harder for Arcapita to access the US Bankruptcy Courts (Sprayregen et al. 2014).

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