



PROFIT SHARING IN THE CONTEXT OF *MUḌĀRABAH*
AND ITS RISK MANAGEMENT IN THE MODERN
ISLAMIC FINANCIAL INSTITUTIONS

BY

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ABSTRACT

The evolution and introduction of Islamic financial institutions in the last three decades have generated issues and arguments among Muslim economists, scholars and practitioners. What is in relation to the theories of profitsharing in the context of *mudārabah* and its risk management in the modern Islamic financial institutions (MIFI) have remained the most discussed issues in the Islamic financial industries. The present study analyses profit sharing in the context of *mudārabah* and its risk management in the modern Islamic Financial institutions (MIFI) by examining the application of *mudārabah* and its constituents from the classical perspective to the contemporary issues. The study scrutinizes and answers the research hypotheses by using surveyed data from Islamic financial institutions in Malaysia. The construct validity of Modern Islamic financial Institutions (MIFI) reveals that profit sharing (PS) in the institutional context is explored by several approaches; *mudārabah* application from classical to contemporary issues. It evaluates the basis of PS theory by considering the relevant literature on *mudārabah* and risk management in Islamic financial institutions by establishing fundamental issues which add to one of the challenges faced by modern Islamic financial institutions (MIFI). The study adapted the actual analyses and implementation of the measurement framework together with the findings from the survey. The survey data used for this research was drawn from a population of 274 staff in 11 Islamic financial institutions in Kuala Lumpur, Malaysia. The study suggests a process by evaluating the data analysis process of profit sharing in modern Islamic financial institutions (MIFI) and understanding the risk features surrounding Islamic financial institutions. The study utilized the quantitative research paradigm for which requisite data were procured and analyzed to feel the bespoke measurement framework. The analysis of the determination of profit sharing was explored in the data collection based on variables presented in the Islamic financial institutions. It covered the statistical findings for the identified sample used in the research. The relationship between Islamic foreign institutions and Islamic local institutions were suggested based on the results of the data analysis. The analysis reveals that out of five hypotheses, two of them have significant risk management pertaining to the features of IFIs and found significant theories associated with PS in IFIs between local and foreign banks and *mudārabah* principles. Ultimately, the study of the data analysis has answered the research hypotheses that MIFI based on the PS mode are concerned with establishing consistency within repeated measures. Therefore, these research findings can be used as an impulsion for future research on the possibility of introducing a new MIFI model that is highly tenable to attain the same status of credibility and reputation of Islamic financial institutions.

ملخص البحث

التطور التي شهدته المؤسسات المالية الإسلامية في العقود الثلاثة الماضية أسفرت عن إهتماموا الجدول بين الاقتصاديين والباحثين والممارسين المسلمين. ولاسيما ما يتعلق بنظريات الربح في إطار المضاربة وإدارة مخاطرها في المؤسسات المالية الإسلامية المعاصرة (MIFI) ظلت واحدة من أكثر القضايا الحيوية في الصناعات المالية الإسلامية. هذه الدراسة تحلل تقاسم الربح في إطار المضاربة وإدارة مخاطرها في المؤسسات المالية الإسلامية المعاصرة (MIFI) من خلال منظور تقليدي في القضايا المعاصرة. والدراسة تتابع البحث والإجابات عن الفرضيات باستخدام مسحاليبيانات من المؤسسات المالية في ماليزيا. بناءً على ماتوصلت إليه في المؤسسات المالية الإسلامية المعاصرة (MIFI) يُظهر أن تقاسم الربح (PS) في السياق المؤسسي هو يستكشف مناهج عديدة، من خلال تطبيق المضاربة في منظور تقليدي إلى القضايا المعاصرة. وقد قوّمت على أساساً لتنظر إلى الكتابات ذات الصلة بالمضاربة وإدارة مخاطرها في المؤسسات المالية الإسلامية من وضع القضايا الأساسية التي تُضاف إلى واحدة من التحديات التي تواجهها المؤسسات المالية الإسلامية المعاصرة (MIFI). هذه الدراسة تكيفت للتحليلات الفعلية وتنفيذ قياس إطار مع نتائج الدراسات الاستقصائية. وكانت البيانات المستخدمة في هذا البحث تمثل عينة من 274 موظفاً في المؤسسات المالية الإسلامية في كوالالمبور، ماليزيا. واقترحت الدراسة في عملية التقييم، والدراسة، وتحليل البيانات لعملية تقاسم الربح في إحدى عشرة مؤسسة مالية إسلامية معاصرة (MIFI) وفهم المخاطر المحيطة يضم المؤسسات المالية الإسلامية. وهذه الدراسة استخدمت نموذج البحث عنكيفية البيانات المطلوبة التي تم في إطار البحث. لتحليل وتحديد تقاسم الربح بمحقق مشاركة في جمع البيانات على أساس المتغيرات في المؤسسات المالية الإسلامية. ويشمل النتائج الإحصائية في تحديد العينة المستخدمة في البحوث. والعلاقة بين المؤسسات الإسلامية الخارجية، والمؤسسات المحلية، اقترحت على أساس نتائج تحليل البيانات. وقد كشف التحليل أن اثنين من خمسة افتراضات هامة من بينها إدارة المخاطر المتعلقة في ملامح IFIs وإضافة النظريات المرتبطة بـ PS في IFIs بين المؤسسات المالية المحلية والبنوك الخارجية ومصادر المضاربة. وفي نهاية المطاف، دراسة تحليلية للبيانات كشفت عن الردّ فرضيات البحث النتائج الرئيسية، أن MIFI على أساس صيغة PS قد وُضع المعينة لوضع التوافق في الإجراءات المتكررة. ومن ثم، نتائج هذه البحوث يمكن أن تستخدم في المستقبل بالثقافات والتقاليد البحث في إمكانية تقديم نموذج جديدًا لـ MIFI الذي يمكن لتحقيق نفس حالة من مصداقية وسمعة لمؤسسات المالية الإسلامية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated and acknowledged. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Ibrahim Mohamed Haji Bulushi

Signature

Date

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions.
EVA	Economic Value Added
EMS	Environmental Management System
CAPM	Capital Asset Pricing Model
CDO	Collateralized Debt Obligations
CDS	Credit Default Swaps
CLS	Continuous Link Settlement
CoBIT	Control Objectives for Information and Related Technologies
EMS	Environmental Management System
IAIB	International Association of Islamic Banks
IFI	Islamic Financial Institution
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IRB	Internal Rating – Based
IRB	International Rating – Based
IRR	Investment Risk Reverse
ISO	International Standards Organization
IT	Information Technology
JIB	Jordan Islamic Bank
MIFI	Modern Islamic Financial Institutions
OIC	Organization of the Islamic Conference
PD	Product Development
PER	Profit Equalization Reserve
PG	Practice Guides
PLS	Profit and Loss Sharing
PS	Profit Sharing
PSR	Profit Sharing Ratio
PVP	Payment versus Payment
RAROC	Risk Adjust Rate of Return
S	Standards
SAS	Statement on Auditing Standard
SPR 3	<i>Shari'ah</i> Parameter Reference 3
SPP	<i>Shari'ah</i> Public Policy
SSB	<i>Shari'ah</i> Supervisory Board
STP	Straight Through Processing

CHAPTER ONE

INTRODUCTION

1.0. BACKGROUND OF THE STUDY

Islam assumes comprehensive and integration of contracts which defines economic principles in accordance with Islamic law (*Shari'ah*)¹ based on the revelation of the Qur'an. The divine and its application that takes into account the material, spiritual, social and political aspects of human life with accountability, and the efficient and equitable use of resource institutions. In order to understand the way in which economic affairs and financial institutions are to be organized in Islamic *Shari'ah*, it is first necessary to comprehend the nature of this relationship.

It is clear that the contracts in Islam combine the stagnant and developed. The interest and other unlawful transactions are among the things prohibited for the past fourteen century by the Islamic Law. The elimination of *ribā* from Islamic financial transaction is the main feature of Islamic financial institutions compared to their counterparts' conventional financial institutions. The Islamic renaissance, revival or resurgence in Islamic countries contributed a major role in Islamic financial development to enhance the Islamic banking institutions. The Islamic financial institution has expanded rapidly in the globe and specifically in the Islamic countries.

The progression and introduction of Islamic financial institutions in the past decades demonstrated issues and argument among Muslim scholars and practitioners, especially related to the issues of theory of profit which has remained one of the most neglected issues in economics. The works done on the theory of profit by the western

¹The term refers to divine guidance as given by the Holy *Qur'ān* and the *Sunnah* of the Prophet Muhammad (PBUH) and embodies all aspects of the Islamic faith including beliefs and Practice.

scholars are limited while that of the Muslim scholars is even rare. This scarcity with the western scholars in providing adequate materials on the theory of profit has raised an alarm in the subject though there are some books, book chapters or journal articles but still there is a need for further research in order to make the subject understandable in reference to Islamic financial institutions. According to Bashir:

Scarcity of information about Islamic banks is caused by too many factors. First, most of the banking loan contracts are private and, therefore, unavailable to researchers. Second, in most of the countries where these banks operate, financial markets are not well developed. Third, there are no private agencies specializing in gathering and selling information about Islamic banks. Finally, regulators do not hold Islamic banks to periodic disclosure of sufficient information.²

The above information provides several reasons as to why there exist a scarcity of information on Islamic finance and banking. At the moment there is some improvement in their performance compared to a few decades of its evolution.

The issues of profit and loss sharing in Islamic finance have developed to be a wide area of interest in our contemporary Muslim world due to the complication of determining functions related to its application. Therefore understanding the role of profit and loss sharing emerged to be fundamental approach used as a tool of classical Islamic financial transaction. In the Islamic perspective, the profit sharing (PS)³ scheme prescribed by the Islamic *Shari'ah* is a joint enterprise which intends to achieve a just distribution of gain and liability among the joint partners. Taking the ideals and guidelines propounded by the *Shari'ah* and prevailing conditions into consideration.

This study, examines the profit sharing in the context of *muḍārabah* and its risk management in the modern Islamic financial institutions. It examines the origin of the

² Bashir, Abdel-Hameed M., *Risk and profitability measures in Islamic banks: The case of two Sudanese Banks*, *Islamic Economic Studies*, Vol. 6, No.2, May 1999, page 2.

³PS: Abbreviation of Profit and Sharing in Islamic Financial Institution.

Islamic financial institutions with its development to contemporary issues. The study will focus on the application and distributive implications based on profit and loss sharing. The issue of profit and loss sharing is a unique issue in Islamic transaction as it covers a wide range of Islamic financial institutions. The institutional and ethical issues underlying the Islamic finance development with their adoption to *mudārabah* instruments will be examined. The concept of *Shari'ah* pertaining to the PS mode has discovered specific forms of business arrangement to earn profit without indulging in *ribā*. This PS techniques used by the classical scholars has developed an interest among the modern scholars to conduct more research in developing modern conceptual approach based on Islamic law to provide solution on many questions concerning modern Islamic financial institutions. The Islamic banking services have emerged in our modern times as an Islamic approach in providing solution to the conventional banking system in the area of profit and loss sharing.

This study will also focus on the features of Islamic financial institutions and the intermediation models that they follow in implementation of the PS mode in Islamic Finance. These Institutions entail special issues that need to be recognized to help the application of the PS in financial institutions is truly effective. Therefore, the arguments related to the profit sharing in financial institutions such as challenges and determination of PS will be evaluated. The determination of PS would be screened to verify as to whether it is *Shari'ah* compliant.

Finally, the application of this study to *shari'ah* understanding especially in accordance to the school of thoughts in Islamic jurisprudence will be evaluated. Other issues are the comparison of the Islamic financial institutions compared to few issues in conventional system though will not be a full focus due to the limitations of the study.

1.1. STATEMENT OF THE PROBLEM

Profit sharing mode (PS) dominates the theoretical literature on Islamic financial institutions. The issue of PS seems to be very broad and it could necessitate a comprehensive study in order that full justice is done to it. The modern Islamic financial institutions has been criticized due to its application and distributive implementation of the institutions based on profit and loss sharing arrangements with implications related to Islamic financial institutions.

Muslim society has inherited the financial institutions based on conventional perspective while assuming its operation under the *Shari'ah* compliant transactions. Therefore, presenting the PS issues and problems and classifying them according to their type is very valuable for a sustained growth and development of the Islamic financial institutions based on proper understanding of Islamic jurisprudence.

The PS mode in modern Islamic financial institutions covers a number of issues related to the determination of profit sharing which justifies a growth promotion policy for ensuring distributive justice in Islamic Institutions. Among those issues related to PS mode, is the sharing of the risk. Such issues prevent Islamic financial institutions from operating efficiently.

1.2. RESEARCH QUESTIONS

In this thesis, I intend to consider the following research questions:

1. What are the changes on the application of *Muḍārabah* from the classical point of view to the contemporary issues?
2. Are there any theories of profit sharing in Islamic financial institutions and its determination?

3. Does the risk management challenges pertaining to the features of Islamic financial institutions and the intermediary models truly effective?
4. Are there any risk mitigating features in risk management issues?
5. Are there any measures to be taken to mitigate risks and acceptable by *Shari'ah*?

1.3OBJECTIVES OF THE STUDY

1. To examine suitable implementation on the application of profit sharing arrangements from classical to contemporary issues.
2. To evaluate and analyze appropriate theories of profit sharing and resolve the question of the determination of profit sharing and other related issues.
3. To examine solutions by eliminating the risk issues in Islamic financial institutions and its challenges in Islamic finance.
4. To assess risk mitigating features surrounding Islamic financial institutions.
5. To identify steps and measures that are acceptable by *Shari'ah* to mitigate risk.

1.4HYPOTHESIS STATEMENT

1.4.1 Null Hypothesis (Ho):

1. There are no significant changes on the application of *mudārabah* from the classical point of view to the contemporary issues.
2. There are no significant theories of profit sharing in Islamic financial institutions and its determination.

3. There is no significant risk management in challenges pertaining Islamic financial institutions and the intermediary models effectively.
4. There is no significant risk mitigating features in risk management issues.
5. There is no significant measures to be taken to mitigate risks and acceptable by *Shari'ah*.

1.4.2 Alternative Hypothesis (Ha):

1. There are significant changes on the application of *mudārabah* from the classical point of view to the contemporary issues.
2. There are significant theories of profit and loss sharing in Islamic financial institutions and its determination.
3. There are significant risk management challenges pertaining to the features of Islamic financial institutions and the intermediary models effectively.
4. There is significant risk mitigating features in risk management issues.
5. There are significant measures that need to be taken to mitigate risks in the light of the Islamic *Shari'ah*.

1.5 SIGNIFICANCE OF THE STUDY

The study anticipate that the result of the findings of this research is very useful to the Islamic institutions in order to develop better understanding of the Islamic banking discipline and its application from the classical to contemporary issues. In addition, the result will also benefit students of knowledge in universities and Islamic centers to the development of classical understanding of Islamic transaction, comparative juristic interpretation and thoughts which is related to the concepts of the development of