Journal of Islamic Banking & Finance

Global Perspective on Islamic Finance

- Evolution of Islamic Economics: Definition, Nature, Methodology, Problems and Challenges
- Exploring the Impact of Shariah Training on Islamic Banking Employees in Pakistan
- Liquidity Determinants of Islamic and Conventional Banks
- Expounding the Relevance of Retirement Planning from the Primary Sources of the Shari’ah
- Modaraba: A Viable Option for Project Financing
- Capital Structure Decisions in Islamic Banking: Empirical Evidence from Pakistan

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The most Beneficent, The most Merciful

“O Believers: devour not Riba, doubled and redoubled;

and fear Allah, in the hope that you may get prosperity.”

Sura Ale-Imran (verse No. 130)

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Published by:
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Karachi, Pakistan.

Ph: +92 (021) 35837315
Fax: +92 (021) 35837315
Email: ia _ib@yahoo.com
editor@islamicbanking.asia

Website: www.islamicbanking.asia
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# Journal of Islamic Banking and Finance

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## CONTENTS

1. **Editor’s Note**  
   07

2. **Evolution of Islamic Economics**  
   Definition, Nature, Methodology, Problems and Challenges  
   By Professor Dr. Zubair Hasan  
   11

3. **Exploring the Impact of Shariah Training on Islamic Banking Employees in Pakistan**  
   By Syed Ahmad Ali, Prof. Dr. Arif Hassan & Asst. Prof. Dr. Azura Omer  
   24

4. **Liquidity Determinants of Islamic and Conventional Banks**  
   By Oussama Gafrej & Mouna Boujelbene Abbes  
   44

5. **Expounding the Relevance of Retirement Planning from the Primary Sources of the Shari’ah**  
   By Haneffa Binti Muchlis Gazali & Nabil Bello  
   62

6. **Modaraba: A Viable Option for Project Financing**  
   By Muhammad Ali Shaikh  
   74

7. **Capital Structure Decisions in Islamic Banking:**  
   Empirical Evidence from Pakistan  
   By M. A. Rehman Shah, A. Rashid & M. Khaleequzzaman  
   88

8. **Book Review:**  
   Readings in Microeconomics: An Islamic Perspective  
   104

9. **Country Model:**  
   Kenya  
   106

10. **Islamic Capital Market Indicator**  
    107
Hamdard, meaning one who shares your grief and misery and provides comfort and relief is a friend indeed. Truly, for over a century, Hamdard has remained not only a compassionate companion but also a benevolent healer.

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Editor’s Note

From economic theory, we know that savings is part of income which is not consumed in a period, while investment is expenditure on fixed assets (real estate and capital equipment) in a period. In its economic effects, asset backed Islamic banking tries to ensure that savings convert to investments naturally and necessarily. In a lot of Muslim-majority countries, the savings ratio is very low. Part of the reason why savings culture is weak, is that Muslims prefer not to invest in interest-based investment options. This presents an opportunity for Islamic banks to increase their outreach, especially in Muslim majority countries. This will help the Muslim majority countries to reduce savings–investment gap through Islamic banking which is directly focused and related to real sector of the economy by its very foundational principles.

As at December 31, 2016, Islamic banking in Pakistan is an established industry with 11.7% and 13.3% market share in total banking assets and deposits respectively. The industry experts are further aiming at a 20 percent market share for Islamic banking in the overall banking industry by 2020. There are 4 full-fledged Islamic banks operating in the country along with 16 conventional banks with Islamic banking branches. By year-end 2016, the total Islamic banking assets in Pakistan stood at Rs 1.85 trillion while the total Islamic banking deposits stood at Rs 1.57 trillion. With increased participation of conventional banks in Islamic banking industry, the branch network has swelled to 2,322 branches by year-end 2016.

Islamic banking regulators and patrons in the country must bear in mind that Islamic banking in Pakistan should graduate from a small niche for faith-conscious target market to become a key player in the banking industry. Only by doing this, the country can hold onto the promise of being an ideological beacon for the Muslim world. According to respected Shaikh Mufti Taqi Usmani, this requires concrete and objective targets with clear time frames so that a direction is set and the performance can be reevaluated in different phases.

Pakistan’s economic outlook seems bright with a B and B3 rating given by Fitch and Moody respectively for the year 2017. Size of the economy in nominal GDP terms
has rocketed to $300 billion with 5.3% annual GDP growth estimated for FY17. The $62 billion Chinese investment in China Pakistan Economic Corridor (CPEC) and inclusion of the country’s premier equity bourse in MSCI emerging market index show healthy signs of economic and capital market development. With at least 6 Pakistani universities ranked in QS Asia Ranking for 2017, the country can also lead in Islamic finance education. Three state of the art Centers of Excellence have been established in the country, but the country’s major universities also need to design Islamic finance education programs to meet the human resource needs of budding industry of Islamic finance in the country.

Going forward, with renewed focus on Islamic banking by the central bank in Pakistan and the revival of economic growth in agriculture sector, the Islamic banking industry is hoped to achieve further prosperity and growth.

This issue of Journal of Islamic Banking & Finance documents scholarly contributions from authors around the globe. Contributions in this current issue discuss the theoretical underpinnings of an Islamic economy, contemporary issues in Islamic finance and performance based empirical studies on Islamic banking and finance. Below, we introduce the research contributions with their key findings that are selected for inclusion in this issue.

Dr. Zubair Hasan, a former Professor of Islamic Economics & Finance, INCEIF, Kuala Lumpur, Malaysia in his paper “Evolution of Islamic Economics -Definition, Nature, Methodology, Problems and Challenges” very interestingly traces the development of Islamic economics over the years, seeks to give it a relevant definition and discusses how Islamic Economics seeks a middle ground between capitalism and socialism, embracing what is good in both towards a just and equitable economic system. He goes on to talk about challenges facing an Islamic Economic system and how some of these can be tackled.

“Exploring the Impact of Shariah Training on Islamic Banking Employees in Pakistan” is contributed by Syed Ahmad Ali, Prof. Dr. Arif Hassan, Asst. Prof. Dr. Azura Omer all affiliated with the Department of Business Administration, International Islamic University Malaysia. They have attempted to determine the training needs of employees of Islamic banks by conducting unstructured skype interviews of a limited number of such bankers in Pakistan. While the sample is limited, in-depth interviews reveal that basic level of training is required for all working in an Islamic bank. However respondents were differing in views as to how much and at what official hierarchical level such training is optimal. This is an interesting study and while not attempting to reveals the lack of understanding training plays in maximizing employee potential in Islamic bankers.
The paper entitled “Liquidity Determinants of Islamic and Conventional Banks” contributed by Oussama Gafrej, a Phd student and Mouna Boujelbene Abbes, Assistant Professor of Finance, both at University of Sfax in Tunisia, is aimed at examining some of the specific to bank and macroeconomic variables, that impact the liquidity of Islamic Banks and of Conventional Banks. The researchers use past studies to formulate their numerous hypotheses and research modeling based on historic data of these banks between the period between 2006 to 2013. They find that of macroeconomic variables, inflation has a significant and negative impact on banks liquidity. Another interesting finding of the study is that Islamic Banks are less susceptible to the variables studied than are conventional banks. Islamic Banks, they say have more liquidity than their conventional counterparts thus having the ability to absorb excessive withdrawal of funds and to pay off shorter term obligations.

Hanefia Binti Muchlis Gazali and Nabil Bello, both associated with International Islamic University of Malaysia in KL in their article “Expounding the Relevance of Retirement Planning from the Primary Sources of Shariah”, take up a less studied topic and give references from the Holy Quran and Hadith of the Prophet Mohammad (pbuh), that can be interpreted to indicate planning for the future and for those working for their retirement years. While the article focuses on the necessity of retirement planning in context of one’s finances, it hints at the need of Shariah compliant financial products for this purpose too.

“Modaraba: A Viable Option for Project Financing” authored by Muhammad Ali Shaikh, a retired senior banker and retired professor of engineering economics at NED University of Engineering and Technology, Karachi, Pakistan now teaching Islamic Banking at different forums in this article compares conventional project financing (PF) to limited recourse financing (LRF). He argues that LRF relies mainly on project cash-flows and thus close resembles Modaraba financing and can be used as a viable alternate to PF. He discusses the benefits of such an alternate and how it can better fit and serve Islamic Banking needs.

“Capital Structure Decision in Islamic Banks: Empirical Evidence from Pakistan”, a paper co-authored by M.A Rehman from University of Engineering and Technology, Taxila, A. Rashid and M. Khaliquzzaman both from the International Islamic University, Islamabad, also examines bank specific and macro-economic variables as these impact the Capital Structure decisions of an Islamic Financial Institution. The researchers use bank specific data of 5 full fledged Islamic Banks and 5 Islamic Window banks, inflation data from SBP reports and IPI data from IFS reports of the IMF. Like the previous paper,
these researchers too use econometric modeling to examine the data. It is an interesting paper the findings of which can provide a indicative guideline for capital structure decisions.

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Evolution of Islamic Economics Definition, Nature, Methodology, Problems and Challenges

By
Professor Emeritus Dr. Zubair Hasan

Abstract
Since the ill-conceived separation of finance from Islamic economics proper in the literature, the latter has landed in confusion and neglect. Of late, much concern is being voiced on this state of affairs; divergence of views on various aspects of the subject tends to grow, cohesive efforts are missing. It is in this context that the present paper takes a hurried look at the evolutionary process of the subject and examines the definition, nature and scope, the issue of methodology, system approach, the problems that seem to beset its growth, the challenges it faces and how can same of these be faced.

Key words: Islamic economics, methodology, economic systems

1. Introduction
One distinctive feature of Islam is its candid rejection of asceticism. Islam exhorts mankind to enjoy all permissible things in life. To that end, Allah has stocked the Earth and the Heavens with His inexhaustible resources and made them yield to human will and effort for their use. Thus, a substantive part of Islamic jurisprudence, known as fiqh muamlat, deals with issues relating to the treatment of natural resources, land especially, production, consumption, trade, commerce, income, wealth, property, taxation, financing etc.

The classical jurists\(^1\) discussed the muamlat in minute details albeit they were not always unanimous in their interpretations of the divine law. Interpretive differences

---

\(^{1}\) Such as Abu Yusuf (d. 798), Al-Mawardi (d. 1058), Ibn Hazm (d. 1064), Al-Sarakhsi (d. 1090), Al-Tusi (d. 1093), Al-Ghazali (d. 1111), Al-Dimashqi (d. after 1175), Ibn Rushd (d. 1187), Ibn Taymiyyah (d.1328), Ibn al- Ukhuwwah (d. 1329), Ibn al-Qayyim (d. 1350), Al-Shatibi (d. 1388), Ibn Khaldun (d. 1406), Al-Magirizi (d. 1442), Al-Dawwani (d. 1501), and Shah Waliyullah (d. 1762). See Wikipedia: Islamic Economics
indeed lend space and flexibility to the system while keeping its ethical hard core undiluted. The ethical content and direction was conditioned by the worldview that Islam projected\(^2\).

The term Islamic economics never occurred to the classical scholars though the evolution of the subject in thought and methodology has shown strong proclivity to revert back to their works.

The continuing ‘pull back’ effect has indeed been a constant source of confusion and controversy on issues like the definition, nature and scope of Islamic economics\(^3\).

The evolution of the economic ideas enshrined in *fiqh muamlat* continued to grow as the Islamic renascence movements gathering momentum for freedom from the colonial rule in the Muslim lands. For, these economic ideas provided a handy and non-provoking method to attacking the Western ideologies both of capitalism and socialism as opposed to Islamic ethos, and were labelled as exploitative of the masses. An important source of such preparatory writings was the Indian sub-continent.

The proliferation of works on economic ideas of Islam across countries started attracting much attention during the latter half of the twentieth century when most of the Muslim nations had won their geo-political independence from the colonial rule. This set the stage to the launching of Islamic Economics in a formal way in mid-seventies.

The first International Conference on Islamic Economics held at Jeddah in 1976 endorsed a program to erect the infrastructure to launch the subject as a formal academic discipline in a big way. Three international Islamic universities were started, one each at Islamabad, Kuala Lumpur and Kampala, new centers, institutions and departments for teaching and research on the subject were added to existing universities and two new academic journals were launched to promote the literature and disseminate information. Islamic economics had arrived. A stock taking of the progress made was initiated at the Second International Conference held in March 1983 at Islamabad where 25 research papers –14 in English and 11 in Arabic – were presented and a future course of action was mooted.

\(^{2}\) The term worldview implies as to how an individual or a community looks at the purpose of life, especially the relationship with other human-beings, with the universe at large and with the Creator of both. Secular worldview divides human conduct into economic and non-economic, the former governed by rationality guided by self-interest. In contrast, Islam sees life as a composite whole where ethical values govern human conduct and attainments in this world are ruled by the concerns of the hereafter. The distinction makes the mainstream and Islamic economic discipline different on many counts definitionally.

\(^{3}\) This apparently is common to the evolution and progress of various branches of knowledge. For instance, even the mainstream economics has undergone and is undergoing this process since its acclaimed origin in Adam Smith (1776). Even its name was not firmly fixed until the close of the nineteenth century. Alfred Marshall’s *Principles* (1898) opens with the words: “Economics or political economics …”. One reason of Islamic economics being in a state of flux could be its being still in early steps on road to maturity.
2. Brief history

Footnote 1 above has already underlined the informal beginnings of Islamic economics and the major contributors to its evolution; their explanations going back to the Qur’an and Sunnah. Here, we carry the story forward, providing in brief the progress of the subject after 1975 when it started emerging as a formal academic discipline. A good account is provided in occasional literature surveys, but a systematic historical analysis probably first appeared in a paper of Abdul Azim Islahi (2010). Nagaoka Shinsuke (2012) in his well-documented research provides a ‘Critical Overview of the History of Islamic Economics’. A notable account of the ‘Current State of Knowledge and Development of the Discipline’ is also available in Khaled A. Hussein (2013). The data needs updating. The following may be seen as the main milestones on the forward march of Islamic economics. Notice that as of 2008:

Eight magazines were started which were "exclusively devoted to Islamic economics and finance".

484 research projects had been finalized in various universities of ten countries including the US, the UK and Germany.

200 Ph.D. dissertations were completed at different universities of the world, literature was proliferating in English, Arabic, Urdu, Bhasa Malaysia, Turkish and other regional languages.

Organization of periodic seminars, workshops and conferences – local and international – had become a major instrument to promote dialogue, research and dissemination of knowledge worldwide. Eight magazines were started "exclusively devoted to Islamic economics and finance

484 research projects in various universities of ten countries including the US, the UK and Germany had been completed.

200 Ph.D. dissertations at different universities of the world in English, Arabic, Urdu, Bhasa Malaysia, Turkish and other regional languages are currently available.

"Over a thousand unique titles on Islamic economics and finance" are listed in IFP database.

1500 conferences (with proceedings available in IFP databank) have been held. A detailed account on the main series is provided in Munawar Iqbal (2008).

3. Definition

A generally acceptable consensual definition of Islamic economics has not yet emerged even after more than six decades of its formal/informal existence (Iqbal, Syed Ali & Muljawan Eds. 2007, p.4). Several reasons have impeded the progress in that direction. First, the task of formalizing Islamic economics was initially taken up by
religious scholars. They worked hard with devotion, earnestness and humility. They successfully raised the edifice of the Islamic economics, expanded educational institutions and courses in the area, brought out journals and attracted professionals from the mainstream to enrich and give the subject a modern look and acceptability. Great contribution it all was and deserved every praise it deserved.

New entrants to the discipline were sought and encouraged but there was a discernable preference for those linked to the Islamic revivalist movements in matters of recognition and employment. A sort of school of thought seemed to have developed in Jeddah (Hasan 2005, 12-13) having common position on the approach content and thrust of Islamic economic ideas. With occasional departures, concepts like scarcity of resources, pursuit of self-interest, and maximizing behavior on the part of economic agents and what followed in their wake was mostly thought extrinsic to Islamic economics; nay they were acclaimed the defining departures from the secular mainstream economics. This created a lot of difficulty confusion and inconsistency in defining the subject and its nature and scope. There is yet no commonly agreed definition of Islamic economics, there is rather a welter of them characterized with ambiguity and eclecticism.  

The historical ‘pull back’ on the one hand and resistance to it on the other have divided the Islamic economists into two broad strains – retrogressive and forward looking. The former insist on a puritan all-or-nothing approach to develop Islamic economics. They reject the mainstream economics lock stock and barrel. To them, it contains nothing worth Islamic approval. Contextual to ground realities, they are little more ivory tower thinkers and offer little that is operable in the current times, even in Muslim countries. In contrast, there are those who argue that Islam never divided knowledge into Islamic and non-Islamic. It takes the available stock of knowledge, advocates for using Islamic filters to accept what passes through and reject what does not even after modification in the light of Shari’ah norms. It is this sort of filter-modify-filter approach’ that is gaining ground in the more recent writings in Islamic economics.

In between are those who are seen lurching between the two more definitive positions; not a few among them have chosen to revise their earlier positions. There is now increasing realization that mainstream economics contains much in terms of argumentation, analytical tool and modes of presentation for absorption with advantage. Importantly, the denial of resource scarcity has almost vanished, pursuit of self-interest conditioned by the Islamic ethical norms is accommodated, and maximizing behavior is

---

4 The IDB Prize award lecture of M. U Chapra (1996) discusses the definition of Islamic Economics in pages 33-35. In his footnote 32 he has reproduced without comment the definitions of the subject in the writings of S.M. Hasanuz Zaman, M. A. Mannan, Khurshid Ahmad, M.N. Siddiqi, and M. Akram Khan, To Chapra himself Islamic economics could be defined as “that branch of knowledge which helps realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances.” Necati Aydin (June, 2013) adds Hasan’s definition of Islamic economics to Chapra’s list and reviews them all in terms of what he spells out as a new paradigm in pp. 27-29
not rejected out of hand. The change has permitted a firmer definition of Islamic economics; one being as follows.

“**Islamic economics is the subject that studies human behavior in relation to multiplicity of wants and scarcity of resources with alternative uses so as to maximize falah that is the well-being both in the present world and in the hereafter**” (Hasan 2015, 4).

The incorporation in the definition of the notion of ‘Falah’ to which the call to prayers invites the believers to come from the minarets ten times a day is indeed the epitome of what Islam requires of mankind – using the material means to achieve solace in the hereafter (Qur’an 28:77). It is expressive of the prayer that believers address to God after each prayer:

“**Lord! give unto usin this world that which is best and in the hereafter that which is best, and save us from the torment of fire**” (Qur’an 2: 201).

In addition, the definition closes the gap between the mainstream and Islamic disciplines, yet keeping the two distinct because of world view differences. Centering on Amanah. Some of the important concepts are in streamlining process\(^5\). To repeat, denials of resource scarcity relative to multiplicity of wants has almost vanished, pursuit of self-interest within ethical bounds is no more frowned at. Above all maximizing behavior on the part of economic agents is entertained with conditions. The message of Islamic religion unlike of other faiths is not time-space bound, it is for all humanity independent of time and space. It is cosmopolitan and eternal. The definition of Islamic economics must exhibit this recognition; it cannot remain confined to the believers only. The above definition has universal message and appeal.

4. **Nature and scope**

Islamic economics is and must remain a scientific body of knowledge. For, it admits the use of reason and analogy to establish cause and effect’ relationships. The

\(^5\) Hasan, Zubair (July, 2014) clarifies the prevalent misgivings about three foundational concepts in mainstream economics. These are scarcity of resources, pursuit of self-interest and maximizing behavior of economic agents. He finds their use inevitable for Islamic economics. He argues that stocks of resources that God has provided are inexhaustible. But important is the availability of resources out of stocks to mankind. Availability is a function of human effort and the state of knowledge about resources over time and space. In that sense resources are scarce in relation to multiplicity of human wants for Islamic economics as well. Self-interest must be distinguished from selfishness. The motive operates on both ends of human existence: mundane and spiritual. Its pursuit does not preclude altruism from human life. Counter interests keep balance in society and promote civility. Islam recognizes the motive as valid. Maximization relates to quantifiable ex-ante variables. Uncertainty of future outcomes of actions makes maximization a heuristic but useful analytical tool. The concept is value neutral. What is maximized, how and to what end alone give rise to moral issues. Modified in the light of Shariah requirements the three concepts can provide a firmer definition for Islamic economics centered on the notion of falah”.
Qur’an, in fact, does not shun rationality; the scripture contains many positivist statements. It invites mankind time and again to see reason and use their intellect and experience to understand the Creator and his creation and exhorts people to enrich their life in this world and in the hereafter. Based on religion, Islamic economics has of necessity a dominant normative overtone. Since Islam prescribes a way of living in this world, it avoids idle theorizing. Principles of Islamic economics are essentially the principles of economic policy. The subject holds both positive and normative content. At the same time, it also prescribes action programs and guidance to achieve *faJah*.

As a point of departure, it is at times contended that mainstream economics is value neutral while Islamic economics is value-based. This is not true. For, mainstream economics too is not free of value judgments. Values are inbuilt in its basic assumptions – freedom of enterprise, private ownership of property, market arbitration, competition, non-intervention and so on – fall in the category. Finally, not to have a value is also a value, as K. J. Arrow once put it.

These assumptions exist because of social approval and can also be changed or modified through social agreement. In Islamic economics values are God ordained; human beings can impart to them limited interpretive flexibility; they cannot abolish or replace them. Thus, both economic disciplines have values; the difference lies in their source and the extent of human discretion in the matter. And this does make a difference.

### 5. Methodology

Methodology of economics broadly consists of the set of criteria, rules, and procedures which the philosophers of the subject have evolved over the years to examine its nature, scope, and performance given the goals, over time and space. On the contrary, in Islam usul-al-fiqh serves as the methodology to generate and supervise fiqh-al-muamlat. Both are parts of Islamic economics and operate to achieve not any man-made goals but the *maqasid ur the* objectives of the Divine law. The role of intellect is to impart interpretive flexibility within the given framework, not beyond it (Hasan 1998, 17 – 24).

Mainstream writings on methodology proliferated after the 1950s but the wave subsided before the close of the century. The subject increasingly ran into so much abstraction and controversy that its study was shifted from the departments of economics to that of philosophy at many universities across the globe.

It is interesting that while attention to methodological issues tended to wane in mainstream economics literature, it gained ascendancy in the field of Islamic economics.

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6 Islam being a cosmopolitan religion that addresses the entire humanity the pursuit of *maqasid* is not exclusive to the believers. The question then is that if the followers of other religions can interpret them the way it would suit them? The point needs clarification.

Several prominent scholars including Al-Attas (1995), Massod Alam Choudhory (2007), Assad Zaman (2013), Abbas Mirakhor (2007), and Mohammad Aslam Haneef (2011) dub most of the current literature coming out on the subject violative of Islamic law and intent from methodological norms as they interpret them. As such they reject most of it as mimicry of the mainstream neo-classical economics. One may grant them the positions they take but the difficulty is that they do not go beyond rejection prescribing little operable under the prevailing circumstances of the Muslim world. A cruel example is that a high powered committee was set up in 2010 on the IDB initiative under the chairmanship of a remounted Pakistani scholar to write a textbook on Islamic economics for use in teaching Islamic economics in the higher education institutions. Six years have gone by, but the book has yet to see the light of the day. Individual contributions in the area also failed to win approval.

6. Economic systems

Islam prescribes a way of living in this world for salvation in the hereafter. The Divine law demands ground demonstration; idle theorizing has little value in the Shari'ah. Thus, Islamic economics started with writings on the Islamic economic system. The first systematic comprehensive and extensively documented treatise on the subject was The Economic System of Islam (broad outlines) in Urdu language. Written by Maulana Hifzur-Rehman Seoharvi, the Secretary General of Jamaat-e-Ulma-e-Hind, the book was first published by Dar-ul- Mussanifeen, Urdu Bazar, Delhi-6 in 1936 and went into six editions, the last appearing in 1946. The Maulana was the pioneer of Islamic economics in the Indian sub-continent. With the later day writers on Islamic economics, Maulana’s System never won the recognition it deserved. Presumably, the reason was a political divide: Jamaat-e-Ulma-e-Hind of the Maulana was with the Congress in freedom movement of India opposing the partition of the country while Islamic economics after partition became the prime concern of Jamaat-e-Islami that now stands divided into three segments – Pakistan, India and Bangladesh – bound with common academic thought and agenda. Possibly, the magna opus of the Maulana - a truly encyclopedic work - could not fit into their scheme of aspiration and program. Copies of the work in Urdu with an introduction in English written by Zubair Hasan are available in the main libraries of the International Islamic University (IIUM) and INCEIF The Global University of Islamic Finance two leading seats of Islamic instruction in Kuala Lumpur, Malaysia.

Economic activity operates in a broad organizational framework called economic system. The framework consists of economic entities like households, business firms, public institutions, markets and so on. They are constituted and operate according to a set of rules of conduct governed by doctrine or societal worldview. The main components of such a system making that of Islam different from the two other capitalism and socialism are as under.

1. Axiomatic differences: Axioms refer to what a system believes as self-evident truths; they emanate from the worldview a society upholds. To illustrate capitalism in principle believes in freedom of enterprise, public non-intervention in economic matters, market arbitration and competition as
a regulatory force ensuring public good. Also, it sees no clash in general between individual and social interest in this setting.\(^9\)

In contrast, socialism, shorn of its shades and details, as a norm is opposed to freedom of enterprise that must result in a capital-labor clash leading to the exploitation and suppression of the workers. It believes in public ownership of productive resources and planning by direction to ensure socially conducive allocation of resources and distributive justice resultant peace and harmony.

Islam seeks the middle path between capitalism and socialism. It accommodates the axioms of capitalism but in a reformed and socially beneficial form as per Shari’ah norms and directions. In its thrust and direction, the system is pro-poor without being anti-rich; it seeks to convert man’s this world ambitions as a means for salvation in the hereafter. Tolerance, patience, humanism and justice are its guiding principles.

Property rights: The Islamic system, like capitalism, allows the private ownership of property but with a difference. It enjoins on property owners to hold it not for self-use alone (Qur’an 2:29). Unlike capitalism, Islam under its celebrated concept of *Amanah*, assigns rights to others, especially the poor and the deprived, in one’s wealth. These rights have to be honored. The scripture exhorts the believers to spend in the way of Allah for social good not less than a prescribed minimum.

Operational mechanism: Allowing private ownership of property in Islam implies freedom of enterprise, pursuit of self-interest and seeking of maximization of gains, of course subject to Shari’ah constraints\(^10\). Islam approves competitive markets and upholds price mechanism operations devoid of interest, indeterminacy and speculation that mar fair-play imperative it insists upon. It disapproves of the socialist control and regimentation of markets.

Societal priorities: Capitalism works, as its name implies, for promoting and safeguarding the interests of capital owners. In that, it gives more weight to individual liberty and freedom of action compared to societal aspirations and well-being. Socialism seeks to reverse these priorities. Islam allows individual guided liberty to develop and utilize his full potential to benefit

\(^9\) On the axioms of Islamic economics see also Syed Nawab Haider Naqvi

\(^10\) There has been much confusion and debate on the maximizing behavior of economic agents in Islamic economics and the issue remains in a state of flux. Mohammad Akram Khan (2013, 42) commenting on the illogic of resistance to the proposition wrote in his well-received publication *What is wrong with Islamic economics*, Edward Elgar, seems to have clinched the issue when he wrote, “A respectable exception is Hasan (2005, 32) who argues that maximization behavior has to be seen in the context of “what” and “how” before a final verdict can be given.”
himself and help others. Individual exists in a society not outside – a wave has a personality in the ocean not outside. Thus in Islam societal interest and well-being gets precedence over that of the individual in case there is a clash. Thus, scarce economic resources have to be utilized to produce those goods that meet the basic human needs of food, clothing, shelter, education and health care.

7. Problems

Islamic economics is at present in a muddled state and lacks direction. Part of the problem can be traced back to its originating in the writings of the men of religion who found them socially marginalized during the long spells of colonial rule over the Muslim lands. They did much laudable work that helped preserve the Islamic identity of the community and also provided them with a living. More than positive contributions to society, they tended to keep the masses away from modern education to save them from imbibing the cultural values of the colonial bosses. By the time, foreign rule ended and independence dawned over the Muslim lands after the Second World War, the community had already been divided vertically between those equipped with Western education and those remaining stuck in narrow religious confines.

Independence bestowed power in Muslim countries to the minority having modern education leaving the religious leadership and their poor followers high and dry. The latter started Islamic movements across the Muslim world primarily to capture political power. Islamic economics no longer remained a pious scholarly pursuit; it increasingly tended to became part of their political ploy. Islamic movements could seldom capture political power, or retain it where they could, because of the Western mechanizations including armed intervention underpinned by the assumption of the clash of civilizations.

Nevertheless, Islamic movements did succeed in getting minor/major concessions from the ruling classes and substantive financial support from the various state organs for Islamic economics and finance; the subjects soon emerging to attain the status of an academic discipline winning recognition across the non-Muslim world as well.

This indeed is a great and laudable achievement of the Islamic movements over time and space. However, on this road to progress, the discipline has also courted some serious afflictions. With the passage of time and with wider recognition, the movements’ dominance of Islamic economics and finance education is slackening; they could not keep out, had to rather welcome, the non-movement professionals to enter and enrich the discipline. This has created some difficulties.

a) The old guards have revived, rather sharpened, their attacks on the Western Capitalism to establish the superiority of the Islamic alternative to replace it. The point here is not how valid or effective is their criticism or contentions. The point is how valid it is to compare the ideals of a non-existent Islamic economic system anywhere across the globe with the weaknesses of capitalism as it is in operation? To me, it is an unfair chalk-cheese comparison proving nothing.
b) At the other end, the new enthusiasts, the professionals educated in the West with their degrees enjoying a premium in the emerging economies, especially the Muslim, have claims on Islamic economics. Conditioned in the Western mode of thinking, they want Islamic economics, especially finance, to develop along the road of empiricism knowing full well that Islamic ethical norms and intentions cannot be quantified and the data they use seldom has the needed moral content (Hasan 2007).

c) In between, has emerged a new group of Islamic economists: The Muslims retiring from the international financial institutions – the IMF and the World Bank. Barring exceptions, they are not worth the premium Islamic educational institutions put on them as the ‘experts’. For, their appointment to international institutions are not always on merit or by competition; political they are – governments of member countries appoint them as their representatives as per area quotas.

The educational, cultural and attitudinal differences among the academia working in the higher learning institutions coming from very diverse sources has detracted from developing a cohesive, consistent multifarious and directional body of literature in Islamic economics.

8. Challenges and future

Islamic economics faces some serious challenges for its survival as a distinct academic discipline.

- In the forward march of any educational system – Islamic or secular – dread of change is the greatest stumbling block. It may remain rooted in the past, but the past can never be the present or future of a living social organism. Conservatism appears to be the millstone of Islamic economics, not contributing an iota in practical terms. There is no merit in finding faults with others unless one can demonstrate what one preaches as being superior in competition with the rivals on ground. Demonstration wins’ conviction, not contentions.

- Rising fashion of econometric modeling in Islamic economics and finance is harming the cause of purposive research. It lacks theoretical bases, data compatibility with Islamic norms, results are invariably confirmative – reinventing the wheel – model specific and in most cases non-applicative. It is the most perilous imitation of the Western academic culture. It tends to kill creative thinking and innovation in young scholars and detracts attention from indigenous issues (Hasan 2007). There is no useful idea in economics that cannot be expressed in simple common usage language.

- The serious most challenge Islamic economics and finance faces, is the lack of well-structured and graded course structures and the matching textbooks. Western course formats, content and textbooks in social sciences’ education do not address the relevant domestic issues nor provide cases and illustrations.
appropriate with Islamic disciplines and local issues. Their imitation needs restraint.

- As students in Islamic institutions of higher learning cannot be kept away from the learning of the mainstream secular economics, and Islam indeed does not shun its learning, it is advisable that writers of textbooks on Islamic economics adopt an integrative approach, not exclusive (Hasan 2015, preface).

- Not bulk of the journals brought out by the Islamic educational institutions for publication of researches proliferating in Islamic economics and finance are refereed or well-recognized. A glaring omission is at INCEIF acclaimed as the thought leader in the area of Islamic finance; interestingly, its sister organization ISRA regularly brings out a bi-annual Shari’ah oriented journal on Islamic finance.

Instead of starting their own journals, or promoting the existing ones, there is a distinct proclivity to encourage faculty and students seek publication in Western journals. There indeed is a rat race for publishing there to win recognition, employment and professional growth. New Journals are mushrooming in advanced economies to fill the rising demand and has become a fast expanding business. Journals there charge hefty publication fees. Authors in developing countries, especially Muslim, tend to go in for group-writing to share the publication charge. A scrutiny of some such articles for the quality claimed is called for on a regular basis.

Islamic economics is a social science; it is not theology. Unless Islamic economists shun a retrogressive approach to their subject and appreciate the interpretive flexibility of the Shari’ah to accommodate change that social dynamism initiates, the discipline will carry decreasing economic relevance marring the future. Islamic finance may survive but is likely to be increasingly subsumed by the conventional. There is also a feeling that while Islamic Finance is merely a subset of Islamic Economics, its exclusion from the subject to forge an independent identity has led to the neglect in the teaching and funded research in Islamic economics\(^\text{11}\). Unlike the IDB annual award, mainstream economics does not make such distinction in awarding the Nobel Prize.

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\(^{11}\) Rasem Kayed notes that while a number of universities and institutes of higher learning now offer courses on Islamic economics and finance "most of the courses offered by these institutions pertain to Islamic finance rather than Islamic economics."[Surveying Islamic economics and finance courses being offered as of 2008 by 14 universities in Muslim countries, Kayed found 551 courses in conventional economics and finance, and only 12 courses in Islamic economics and finance (only 2% of the total).]

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Exploring the Impact of Shariah Training on Islamic Banking Employees in Pakistan

By
Syed Ahmad Ali∗
Prof. Dr. Arif Hassan
Asst. Prof. Dr. Azura Omer

ABSTRACT

Purpose – The paper explored the need and role of Shariah training of Islamic banking employees in Pakistan. It also examined the effect of such training on employees’ commitment and attitude towards Islamic banking.

Design/Methodology/Approach – The study used qualitative approach in which semi-structured interviews were conducted online using Skype from Islamic banking employees in Pakistan.

Originality/Value – The research appeared to be among the few on this subject and fulfills the need to understand training needs and its role in the context of Islamic banking employees in Pakistan. The uniqueness of the study is to examine Shariah training effect on employees’ work outcomes.

Findings – The findings revealed that employees working in Islamic banks perceive Shariah training as a necessity to work for and to continue their Islamic banking operations. For different levels of Shariah training, a step by step approach was suggested – basic to extensive. Similarly, for Shariah training, it turned out to impact employee motivation, organizational commitment, occupational commitment, attitude towards Islamic banking as well as performance.

Keywords – Shariah Training, Islamic Banking, Employee Background, Employees’ attitude towards Islamic banking, Industrial Commitment, Organizational Commitment, Skype Interviews, Pakistan

Paper type – Qualitative research paper

∗ Author: Syed Ahmad Ali, Prof. Dr. Arif Hassan, Asst. Prof. Dr. Azura Omer are affiliated with the department of Business Administration, International Islamic University Malaysia. - mail: sahmedzaidi@gmail.com
1. Introduction

Employees’ training is considered among one of the core responsibilities of an organization, specifically in services sector (Ford, 2014). Growing competition in the marketplace in particular has increased the importance of employees’ training as means to enable service organization to better deliver their services (Zumrah, Boyle, & Fein, 2013). For Islamic banks, Shariah compliant training will be the cornerstone of its employee training programs. The importance grows further when it comes to Islamic banking due to strong competition enforced by conventional banks (Beck, Demirguc, & Merrouche, 2013). Every Islamic bank affirms its operations to be in accordance with Islamic laws opposing conventional practices. The strong affirmation is reflected through mission statement of every Islamic bank that explains the purpose of its formation (Ahmed, Shaukat, & Islam, 2013). Similarly, an Islamic bank not only proclaims to avoid Riba (Interest) based transactions but directs its employees to be Shariah compliant (abide principles of Islamic jurisprudence) in true form (Visser, 2013). Shariah compliance being at the essence leads Islamic banking operations to maintain writ of Islamic (Shariah) laws (Muhamad, 2015). This provides an assurance that employees are fully aware and trained to adhere and practice Shariah principles (Muhamad, 2015). Therefore, employees are central in staging a Shariah compliant work environment and so is Shariah training particularly in Islamic banks (Uppal & Mangla, 2014).

Pakistan is among some of those countries where Islamic banking and its core concept is emerging as one of the most dominating domain in banking sector of the country (Feisal, 2015). However, creating awareness of Islamic finance and its different modes and principles on which Islamic banking is based is central in Shariah training (Umer, 2010). Objections are raised on the credibility of Islamic banking not only from external customers but internal as well. It is apparently observed that people have very little or no awareness of Islamic financial system (Iqbal, 2007; Uppal & Mangla, 2014). On the other side Islamic banks in Pakistan are unable to understand the mindset of their employees or potential employees. Shariah training therefore, can play a role to improve employees’ mindset and their approach towards Islamic banking. This study therefore intends to explore the impact of Shariah training on Islamic banking employees in Pakistan.

Islamic banking has undoubtedly produced new scales and dimensions to most of the financial sectors around the world. The building blocks of an Islamic financial institution most importantly an Islamic bank are Islamic law and Shariah principles (Mohammad & Shahwan, 2013). Islamic Banking can simply be defined as “a banking system based on principles of Islamic laws and its practical implementation through development of Islamic economics” (Riaz, Raheel, & Sadiq, 2014). An Islamic bank should not only follow Shariah guidelines and principles but its employees should be well versed with all the underlying principles, guidelines and training of Islamic laws (Uppal & Mangla, 2014). Employees play a key role in organization’s growth and development either financial or non-financial and are considered to be ambassadors, reflecting core values and an important marketing tool (Harris, 2007).
For survival, growth and development, an Islamic financial institution needs skilled and trained employees (human capital) so that competitiveness and performance can be sustained (Aziz, 2005). It is indispensable for an organization to invest in its human capital, building their skills through development and training (Ramayah, Yan, & Sulaiman, 2005). Training in Islamic banking is therefore more related to Shariah training in order to build employee’s knowledge and skills in Islamic banking and to clarify their concepts of Islamic Muamalat (transactions). In order to perform job duties better, one must have relevant skills and training to do so (Vermeulen & Crous, 2000). It is the Shariah training that differentiates an Islamic bank from a conventional one and forms an important pre-requisite of it (Dewa & Zakaria, 2010). Lack of training directly or indirectly influences employees’ commitment towards organization (Meyer & Allen, 1991). Similarly, employees who are more committed towards learning are found more satisfied with their jobs. Due to its centrality and association with many organizational factors, Shariah training leads to further exploration in this study to assess its impact on Islamic banking employees.

2. Literature review

2.1 Shariah Training

Training can be defined as “a systematic organizational process that gives employees the knowledge, attitudes, and skills to help organizations implement their missions and visions (Jabbour, 2013).” Similarly, Shariah is defined as “a system of ethics and values covering all aspects of life including personal, social, political, economic and intellectual with unchanging bearings as well as major means of adjusting to change as inseparable from Islamic beliefs, values and objectives” (Dusuki & Abdullah, 2007). Islamic banks are supposed to fulfill and comply with all requirements of Shariah in terms of their business operations as well as with employer-employee and organization-customer relationships (Siddiqui & Usmani, 2014). Employees, upon whom an organization makes an investment in terms of training and development and whose career development is effectively managed by the company, show high levels of commitment regardless of the level they operate at (Morrow, 2001). This suggest that employees should be subjected to Shariah trainings to achieve better Shariah compliance that will significantly reflect in their career development (Shafii, Salleh, Hanefah, & Jusoff, 2013).

Training specific for Islamic financial institutions should be designed in order to achieve increased level of performance and to optimize employees potential (Gustiawan, 2013). Bridging of performance gap and increasing employee commitment can be made possible by introducing training and development programs that aim to change specific skills and attitude of employees (Sahinidis & Bouris, 2008). Shariah training in Islamic banking aims at building a solid platform of concepts and produces skillful human resource that enhance professionalism, morality, and employees competency (Gustiawan, 2013). Experts argue that the lack of Shariah knowledge of Islamic banks employees, and their ignorance of the underlying principles of Islamic contracts and transactions may become a serious obstacle in the development of workforce (Hasan, 2011). Arguing in favor of Shariah knowledge and compliance Dewa and Zakaria (2012) viewed Shariah knowledge as an essential and imperative requirement for employees embarking in
Islamic banking activities. As such, Shariah training has equal, or even more, importance as that of technical aspects. This is because it represents the rationale behind the establishment of Islamic banks (Hassan & Ahmed, 2002).

2.2 – Organizational Commitment

Organizational commitment is conceptualized in various ways and considered as a psychological bond of an employee towards its organization (Eslami & Gharakhani, 2012). Organizational commitment is also described as "the relative strength of an individual's identification with and involvement in a particular organization" (Mowday, Porter, & Steers, 1982). Researchers view phenomenon of organizational commitment as a consistent behavior towards a certain line of activity. Organizational commitment (OC) is also described as a behavioral approach in which an activity is persistently carried out over a period of time (Griffin & Moorhead, 2011). To explain further, a three component model was proposed by Meyer and Allen (1991) based on the argument that these three components reflect different psychological states or mindsets of employees. In order to have a better understanding of OC, one must have an understanding of all the types of organizational commitment. Some researchers call them “mindsets” instead of components which are indirectly a reflector of employees’ performance (Naveed, Iqbal, Javed, & Hamad, 2014). The three components of OC are affective, continuance and normative commitment which reflect a desire, a need and an obligation respectively in order to sustain in an organization (Meyer & Allen, 1991).

All these forms of organizational commitment are somehow or the other associated with attitude and perceptions of employees that ultimately leads towards a belief forming mechanism (Gilbert, 1991). Employees react in different behaviors forming work related attitudes e.g. job commitment and satisfaction (Anton, 2009). In order to improve employees’ work related attitudes, skills and knowledge development are the key elements that require consistent encouragements and enhancements (Dewa and Zakaria - 2010) through continuous training (Vermeulen & Crous, 2000). The linkage however between training and OC is evident from many recent studies. Employee having a strong belief in and acceptance of an organization’s values and goals are found more trained and motivated to perform their job roles (Ling, Qing, & Shen, 2014). The study therefore explored the role of Shariah training in organizational commitment of Islamic banking employees.

2.3 – Employees’ Attitude towards Islamic Banking

Employees have different viewpoints and they possess different attitudes towards several aspects of their jobs, their career and towards their organization. Different drives take them towards different attitude at the workplace however, the most focal attitudes of an employee are job satisfaction and commitment (Saari & Judge, 2004). Attitude towards a specific belief may affect employee performance in an organization and its impact can be moderated through training (Khattak, Wasim, & Majeed, 2013). It is implied from the above facts that employee attitude towards a certain belief or perception can lead to a low organizational commitment or vice versa. A previous study on Islamic banks in Pakistan
found Islamic banking employees to possess a negative attitude towards Islamic banking practices (Hassan and Ahmed, 2002). Employees’ attitude in this context can be operationally defined as “attitude of employees towards Islamic banking practices including their perception of Islamic products and services”. There is a strong relationship between the degree of belief an employee has in his organizational goals and objectives and the organizational commitment. This degree of belief ultimately forms attitude of an individual and the differences in attitude lead towards high or low performance of an employee (Ijaz & Ali, 2013).

In addition to this, a study conducted by Khan, Asghar, and Zaheer (2014) reveals that most of the employees of Islamic banks in Pakistan have negative perceptions of Islamic banking practices, some of which argue that there are no such existing guidelines given by Islam, while others are of the view that there are guidelines but not implemented in their real terms. Interestingly, they found that one of the primary reasons stand behind this is their lack of Shariah training. Sekaran (1989) argues that these negative vibes may be attributed to the element of reluctance towards the core values of the Islamic banking industry as a whole. Research conducted by Arshad, Aslam, Razi, and Ali (2011), attempted to gauge perceptions of Pakistani employees of both Islamic and conventional banks offering Islamic products. The findings yielded a significant difference in the attitude of employees operating in Islamic banks compared with their conventional counterparts. These differences were mainly attributed to insufficient exposure to Shariah training and the major principles underlying Islamic banking products.

Hassan and Ahmed (2002) assessed customers’ and employees’ perception of Islamic banking in Bangladeshi context. The study reached the conclusion that customers and employees of Islamic banks are ambiguous and unclear about the concepts that constitutes Islamic banking operations. Further, they viewed that transactions practiced in Islamic banks do not differ much from their counterparts causing no difference between the two systems. These studies reflect the mindset of employees that clearly indicate lack of Shariah training. This is true because training that results in improving employees’ attitude plays a crucial role in producing loyal and highly committed employees (Ashar, Ghafoor, Munir, & Hafeez, 2013).

3. Research Methodology

Being a qualitative research, the study employs online interviews for which an in-depth semi-structured interview technique was used. With few limitations to go for a face to face interview, Skype interviews were conducted online. Skype interviews enable researchers to build rapport more easily as compared to face to face interviews without having a lack of privacy and other settings (Oates, 2015). Further, semi-structured interviews allow flexibility to get wide range and in-depth information from each participant. These interviews based on primary data are deemed to be appropriate when the existing knowledge base is poor and when inductive process of data generation involved in such method is anticipated to provide a greater understanding of process and meaning (Rabionet, 2011). The construction of the study was flexible and open. In all communications with informants, the researcher revealed no encoded thought about what responses might be anticipated (Marshall & Rossman, 2014). However, snapshot of an interview guide was distributed among participants to give their personal viewpoint and share their experiences, examples and views. Although frameworks were shaped to allow
the data to be structured and analyzed, their flexibility allowed the researcher to keep openness to all data.

3.1 – Informants of the Study

The initial number of the targeted sample was fifteen, where only thirteen respondents accepted to participate after repeated requests and reminders. Since methodological literature suggests it to be more appropriate to gather data from in-depth interviews from small sample rather than collecting short data from large sample (Yin, 2013). The sample size of this study is adequately sufficient to confirm the findings and to rely upon the quality of the outcomes that are discussed at the end of research. Eleven responses however were shortlisted for transcription and data analysis due to poor audio quality in few interviews – poor signal strength and voice drop were the main issues. The eleven respondents were all male Islamic banking employees working with different departments and at different positions. Five employees out of eleven were working at a managerial position whereas other six were senior officers in different departments. Similarly, the departments these respondents represented include Shariah compliance department, personal banking department, credits administration department, corporate department and operations department. Online semi structured interviews through skype were conducted separately with each participant as per the suitability and availability of their time.

3.2 – Sampling and Data Collection

A sample of knowledgeable and educated Islamic banking employees from three main Islamic banks in Pakistan was selected for this study. A list of questions was used at the start of the interview to guide the informants’ participation. The questions were open-ended and research participants were encouraged to express their thoughts freely on issues pertaining to their banking practices (Marshall & Rossman, 2014). All interviews were audio recorded and then transcribed at the early stages of data collection. Although the poor signal strength caused waste of useful time both for researcher and the respondents, recording was made to ensure the best possible information-capturing standard. Where the quality of recording is known as one of the most important issues in semi structures interviews (O'Connor-2015), it was not less than a challenge to make a sound recording. A sound recording increases the quality as an aspect of rigor in qualitative research, some errors can be prevented and considered non-deliberate (Poland, 1995). Specifically, the poor quality of some tape recordings, which can result from excessive background noise, weak batteries, dirty tape-recording heads, placement of the recording device or microphone too far from the respondent, use of low-quality cassettes, and/or lack of audibility because people are speaking extremely softly (Seidman, 2013). Less controllable but sometimes also a factor is the clarity, speed, and accent of speech used by interviewees.

4. Data Integration & Analysis

After a thoughtful process of integration of data, themes were extracted and analyzed combining the arguments made by majority of respondents with literature support. To satisfy ethical norms and considerations, respondents’ information and identity were kept confidential during the whole research process. Similarly, keeping in view the subjective nature of the responses, validity of data was also examined
(Darawsheh, 2014). For this purpose, two academicians were approached to comment on the findings after extracting themes — both approved the content. NVivo 8.0, a qualitative data analysis software was used for transcribing, coding and interpreting interviews (Woods, Paulus, Atkins, & Macklin, 2015).

The results extracted were based on seven main themes for the study divided into two main categories. The first category is derived from the questions and named as perception of Shariah training that included necessity of Shariah training and level of Shariah training. Similarly, second category was named as impact of Shariah training for which five themes were extracted including employee performance, motivation towards work, organizational commitment, industrial commitment and employee attitude towards Islamic banking. The above mentioned themes are discussed and analyzed one by one according to majority of informants’ responses and views. Figure 1 represents categorization of themes extracted from detailed analysis.

4.1 – Necessity of Shariah Training

The analysis of employees’ response towards the importance and necessity of Shariah training reflected that a considerable majority of respondents view Shariah training mandatory for an Islamic banking employee, especially for those who are directly a point of contact between the customers and the organization. According to majority of respondents, to meet the minimum standards of working in an Islamic bank, an employee should undergo such trainings – no matter how experienced an employee is. For example respondent (A) suggested: “Anybody who is interacting with customers [...] at the very least, they should [...] have Shariah training but it doesn’t mean that others should not have it, it is equally important to them.”

Figure 1: Categorization of themes

Similarly, respondent (B) viewed necessity of Shariah training as: “I think yes it is a very important area, I would call it the backbone of an Islamic bank that helps or enables employees in clarifying[...] clarifying their concepts and doubts.”
This is similar to what Harris (2007) argued that not only Islamic banks should follow the guidelines and principles set by Shariah but the employees should also be well versed with underlying principles, guidelines and training of Islamic laws. Like above two respondents, another employee (D) emphasized the importance of Shariah training as he argued saying: “[…] yes I believe it should be necessary, how can you differentiate or how can I say I am doing differently compared to conventional banking if I am not trained enough to see the difference by myself.”

The respondents largely claimed Shariah training as a tool to improve knowledge base of employees and considered it compulsory for every employee irrespective of Shariah background or a conventional background. However, the respondent who did not consider Shariah training as a necessity for every employee also viewed its importance for further growth and development of an employee. In this context, the respondent (E) noted that:

“it is not […] it is not an obligation or it is not obligatory I will say because sometimes employees have sufficient Shariah background but yes you need it if you want to grow.”

Overall, the respondents showed a good degree of awareness about Shariah training and emphasized its importance for both experienced as well as for fresh employees joining any Islamic bank. These arguments are also supported by Aziz (2005) who brings importance of Shariah training to the foreground arguing that skilled and trained employees are worthwhile to sustain and compete in any Islamic financial institution.

4.2 – Level of Shariah Training

An important element to consider for employees joining Islamic banks is their level of Shariah training that addresses many issues at the very beginning of employees’ career. The interviewees expressed different views on specific level of training – basic or extensive. However, most of them had a consensus about level of training that should follow a step by step approach – basic first, extensive later. In this regard, respondent (F) noted:

“[…] I believe basic training is more appropriate initially…then you can gradually move on to higher level training…as you call it extensive or intensive I forgot. It makes sense as well because logically […] it satisfies almost everyone’s requirements…I mean in every department you go, you should consider first basic level.”

Similarly, in support of this basic training approach (step by step), interviewee (E) viewed it as baseline training that should be given to every employee as he noted:

“of course, you cannot just give someone a high dose medicine straightaway…like you have to give an employee the basic level of training first and then give him some time to digest it and later after some time…like after a year you should re-examine his status of knowledge and skills and then give him extensive training”

The above two respondents viewed basic level of Shariah training as a compulsory level of training and considered extensive level of training to be given at some later stage;
the respondent (D) similarly accentuates on basic level of training but viewed extensive level of training as voluntary or optional as he noted:

“[…]I believe that basic level training is must however an extensive level of training should be optional or voluntary”

The above statements are in line with the findings of (Farook & Farooq, 2011; Siddiqi, 2006) to consider Shariah training as a foremost solution to many contemporary challenges especially in Islamic finance that should address the underlying basic principles related to fiqh-al-muamlat (transactions).

In addition to above respondents, informant (A) argued to provide basic fundamental training to every employee but added to provide extensive training to those who reached certain level of experience or seniority or promoted to certain extent to be well versed with extensive level of training, he noted:

“I think the more, the higher up you go, the more experience you gain, the more years you spend and the more…..more seniority you gain, I think, yes I would agree that you do need a bit more training because you are exposed then to much more different audience…but initially you have to start from basic level of training[…]”

Overall, majority of the employees agree that basic level of training should be given first to every employee but at the same time there was a consensus to give an extensive level of training to those employees who require it – employees who are promoted or gain more experience. Table 1 briefly explains the summary of all extracted themes.

Table 1: Summary of Extracted Themes

<table>
<thead>
<tr>
<th>No.</th>
<th>Division of Themes/Category</th>
<th>Themes</th>
<th>Summary of overall responses</th>
<th>Respondents favoured the theme</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Perception of Shariah Training</td>
<td>Necessity of Shariah training</td>
<td>Employees suggested that Shariah training is necessary and to an extent, mandatory for every employee irrespective of organizational hierarchy</td>
<td>09</td>
<td>69 %</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Level of Shariah training</td>
<td>Majority respondents viewed that basic level of Shariah training should be compulsory for each employee whereas advance should also be given later according to job scope or level of seniority</td>
<td>08</td>
<td>62 %</td>
</tr>
<tr>
<td>2</td>
<td>Impact of Shariah Training</td>
<td>Employee motivation towards work</td>
<td>The response from majority of employees confirmed that with the provision of Shariah training, motivation towards work increased</td>
<td>10</td>
<td>77%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Employees consider Shariah training can certainly improve organizational commitment as it enables employees in bridging their performance gaps</td>
<td>09</td>
<td>69%</td>
</tr>
<tr>
<td></td>
<td>Organization commitment</td>
<td>A majority confirmed that Shariah training can potentially help employees improve their attitude and mind-set towards Islamic banking. They highlighted that Shariah training can play a significant role in understanding both the theory and practice of Islamic banking</td>
<td>08</td>
<td>62%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Attitude towards Islamic banking</td>
<td>Respondents stressed that Industrial commitment is better associated with Shariah training as compared to organizational commitment. They affirmed that if an employee quits a particular Islamic bank, Shariah training will enable him/her to not leave the industry at all</td>
<td>07</td>
<td>54%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Industrial commitment</td>
<td>Employees viewed Shariah training to be vital to improve their performance as it creates awareness in an employee’s mind – in turn it improves his overall performance</td>
<td>07</td>
<td>54%</td>
<td></td>
</tr>
</tbody>
</table>
4.3 – Motivation towards Work

After examining the perception of employees towards necessity and level of Shariah training, employees’ motivation emerged as a common issue that can be addressed by Shariah training. Employees argued differently but majority supported the stance of Shariah training affecting employee motivation towards work – putting an emphasis on how Shariah training can motivate employees and various reasons were identified favoring this phenomenon. The interviewees provided evidence that Shariah training can help in improving motivation of employees in general. In this context, Interviewee (A) noted:

“any employee who understands what they are doing and why they are doing it is necessarily going to be more motivated to do that job well… I think and... clear understanding of the goals of the organization aaa is a big contributing factor to employee motivation, so training, which can lead to a better understanding of the organization and its goals will lead to better employee motivation”

The above statement is similar to what Dewa and Zakaria (2012) viewed about Shariah training: “Skills, knowledge, commitment and motivation are some of the major factors that require encouragement and enhancement. In this context they need to be developed and continuous training plays a vital role in development of these factors.”

The above point raised by respondent (A) can be linked together with what (B) viewed about motivation of an employee working in an Islamic bank or joining an Islamic bank:

“[…]once an employee is working with a conventional bank and later he joins an Islamic bank, or at very start he joins Islamic bank so when employee has training initially or at the inception, you will be... I mean employee will be more clear about what he is going to do, he will put maximum efforts, ultimately he will be motivated and the organization will benefit from it.”

With regards to continuity in training process and how Shariah training increases employee motivation towards work, interviewee (K) responded to bring a new perspective to motivation towards work, he noted:

“it acts like if someone is quite satisfied to do something in a way that satisfies the requirements or our deen (religion) you know that something that is associated with aakhirah (day of judgement) that motivates you to keep doing the work with an intent to achieve Allah’s will”

The respondents as a whole replied affirmatively about the impact of Shariah training on employee motivation and focused more on clear understanding of Islamic banking concept that can be brought forward through continuous process of Shariah training. Majority viewed differentiation between Islamic banking and conventional as an integral part to motivate employees and this clarification can effectively be made through Shariah training.

4.4 – Organizational Commitment

Employees were asked to explain if there is any relationship between Shariah training and organizational commitment. Apart from four respondents, nine replied in an
affirmative way for Shariah training to have a relationship with organizational commitment of employees. The other four did not reply as they lack certainty about Shariah training to influence organizational commitment in its sole capacity. Sharing his views, respondent (B) noted:

“[…]I think there is a very strong bond between Shariah training and organizational commitment because if employees are directed to fill up performance gaps in a way that all their ambiguities related to Shariah related issues are addressed, they will definitely work with dedication and with full commitment.”

This response appeared to be quite similar of what Sahinidis and Bouris (2008) viewed about impact of training on employees about bridging up performance gaps and to increase employee commitment as they highlighted:

“Bridging of performance gap and increasing employee commitment can be made possible by introducing training and development program that should aim to change specific skills and attitude of employees (Sahinidis & Bouris, 2008).”

Similar to the responses above, informant (D) supported the existence of relationship between organizational commitment and Shariah training as he viewed it in this way:

“[…]as you asked about commitment so I believe that once you are clear about your work, once you know that what you are doing is really…in principle with Islamic jurisprudence of what we call Islamic fiqh you know, and your intent is really really to achieve Allah’s will by working against riba based banks then you will feel yourself more committed towards your work”

The above viewpoint identified not only organizational commitment but a reflection to avoid interest based banking system. A similar response was given by interviewee (E) in which he emphasized on halal banking – he expressed his viewpoint as:

“Yeah there is relation because I think when you have Shariah training, your belief gets stronger and stronger of what you are practicing daily is not haram and when you have strong belief you have strong organizational commitment to work hard because you believe that what you are doing is good, it is halal and that will in the end make you more committed.”

The above respondents agreed with Shariah training to impact organizational commitment, however, respondent (G) raised a very interesting argument in favor of this relationship but he linked Shariah training to be an iterative process which is aligned with (Peter, Peter, & Catapan, 2015) who suggested for continuous commitment, continuous training is required. To synthesize viewpoints of respondents, majority viewed Shariah training is positively related with OC. On the contrary, few argued viewing Shariah training not to be the sole factor to increase employees’ commitment towards their organization. To them, Shariah training is not a significant contributor to increase OC.
4.5 – Industrial/Occupational Commitment

Industrial commitment also widely known as occupational commitment was a concept that emerged when employees were asked questions about organizational commitment. Seven out of thirteen respondents viewed it in relation with Shariah training. Experienced employees (serving in Islamic banks) were asked about their viewpoint to leave Islamic banking industry if they will have an opportunity to shift to any conventional bank later. Some interesting points were raised as interviewee (A) noted:

“To be a little blunt, […] I would rather join something else or I will stay where I am…where I am right now if I will have no other opportunity but I won’t switch to any conventional bank…that’s for sure… but if there will be some decent opportunity in Islamic banks (stresses on word Islamic) then I will be happy to grab it.”

The response from interviewee (B) was not much different when he was asked whether Shariah training persuaded him not to switch to any conventional bank as he switched to Islamic banks twice after leaving a conventional bank, he responded:

“Yes, obviously that’s why I said as conventional bank is clearly against the injunctions of Islam so once an employee comes to an Islamic bank, he gets some knowledge through Shariah training and his eyes get wide open and then he whether doesn’t continue his job with one Islamic bank at least he doesn’t switch to conventional bank.”

The above responses from employees generally seemed to be favoring the concept of occupational or industrial commitment and further supported by respondent (D) who gave his father’s example how he became committed to Islamic banking once he left conventional banking. Similarly, interviewee (G) viewed occupational commitment in a different way. His viewpoint not only verified the relationship between OC with Shairah training but also established a link between occupational commitment and Shariah training.

There was however no disagreement between other employees as they did not appear to relate Shariah training with occupational commitment. The overall analysis of these respondents for occupational commitment reflected a better degree of understanding about their job roles and where they position themselves in banking industry – Islamic banking sector in particular.

4.6 – Employees’ Attitude towards Islamic Banking

After a careful analysis of employee motivation towards work, organizational and occupational commitment, the attitude of employees towards Islamic banking was found to be linked with Shariah training. A majority of employees suggested that Shariah training can help in improving the attitude of an employee towards Islamic banking. However, majority of the respondents viewed Islamic banking as not doing a different job than conventional banks – as supported by literature (Loo, 2010). In few respondents’ opinion, employee attitude cannot be improved by Shariah training and other factors should be considered and capitalized for improvement in employee attitude. For those
who argued supporting the impact of Shairah training on employee attitude, also considered Shairah training a significant role player for such improvement. In this regards, informant (I) highlighted:

“So I think […] the most an Islamic bank can do is for […] to have regular Shariah trainings […] for its present employees as well on at least an annual basis so that these employees, who have actual issues can find a forum to discuss their problems with people who have more knowledge and who have more of an idea and understanding of what Islamic banking is all about. Once they will discuss about their reservations, their negative perception will definitely improve, so as their attitude will improve at the end.”

The above informant considered Shariah training as a forum where employees can get their queries resolved and can improve their perception and attitude. Similar to what (A) noted and discussed, interviewee (J) tried to elucidate how repeated Shariah training sessions improved his attitude towards Islamic banking practices. He noted:

“I switched to Dubai Islamic bank many things in me improved after so many repeated training sessions and extensive training sessions […]my concepts got more clarity, my perception, my attitude as I thought Islamic banking and I know … what, how Islamic banking is carried out in Meezan bank and how it is going on in Dubai Islamic bank so I know how an Islamic bank should operate and what are the differences, what are the important elements of any Shariah transactions…[…] I mean the basic principle of Shariah behind that so many things improved.”

Informant (D) described the impact of Shariah training not only on attitude of an employee but his perception and performance as well. He viewed employee attitude towards work as a phenomenon to achieve goals as assigned individually in which role of Shariah training is of vital importance. He affirmatively replied:

“[…] If I am not mistaken, Shariah training is a must to sort this out, I mean goals should be defined to achieve within prescribed time through providing Shariah training that will you know clarify your attitude, your perception and once your attitude will improve, your performance…floor management we call this in general, will improve.”

Although respondent (B) explicated the onus for improvement in employee attitude rests equally on employee and organization, he termed provision of Shariah training from organization as a facilitating role that can enable an employee to sort out his reservations and improve his attitude. Respondent (B) explained:

“I have already explained it that Shariah department is central to resolve such issues …pertaining to attitude of employee…although, employee is also responsible to resolve his attitude problem but organization can facilitate him …I think through training because you will find that a trained employee will rarely complain about his work so in Islamic banks if Shariah training is provided and…attitude will improve and I think should improve.”

Conclusively, a majority of respondents rated Shariah training to be a major role player in improving employees’ attitude towards work. They also viewed Shariah training a significant factor in resolution of attitude related issues in an Islamic banking
organization. Few respondents opposed this viewpoint and considered miscellaneous factors (other than Shariah training) that can effectively improve employees’ attitude towards work.

4.7 – Employees’ Performance

Most of the respondents believe that Shariah training affects employees’ performance. Some view it as an encouragement to work, a motivation or drive to perform better. Stajkovic and Luthans (1998) believe that training enhances employees’ knowledge base that leads to improved self-efficacy resulting in improved performance. These arguments are supported by Srivastava and Agarwal (2014) as they concluded that training improves performance of banking sector employees. Similarly, the study found majority of employees in agreement to the above stated arguments – one of those respondents (A) who observed this impact explained:

“so training, which can lead to a better understanding of the organization and its goals will lead to better employee motivation and attitude and that will definitely lead to improved employee performance. So that is also important.”

The response from interviewee (K) favored encouragement towards work that ultimately helps an employee to improve his performance – aligned with previous studies (Srivastava & Agarwal, 2014). He gave his own example about the process of Shariah training which he had been through and how it improved his performance, he added:

“I would like to give my own example that everytime …I was given training, I actually felt a self-encouragement in me like to put my maximum efforts and I found my performance increased much…increased considerably.”

Quite similar to above respondents, informant (C) being a personal banking officer explained this impact of Shariah training in a context of improved services that reflect employees’ performance. In his views:

“[...]Yeah ...because banking is actually all about services. If you can address them properly that means your services are good and if your services are good then definitely it means your performance is improved…I am actually talking about individual performance but you can also say that organization performance will also go up.[...]”

The above response emphasized on service quality of a bank that can be improved through employee performance. It is further verified by the findings of Ijaz and Ali (2013) who viewed service attitude of employees which effects employees’ overall performance and training and development can improve service attitude as well as employees’ performance. The emphasis drawn by informants almost synthesized the Shariah training with respect to employee performance who viewed it as a prerequisite to work with an Islamic bank – as supported from literature (Habib, 2004). In explaining the impact and benefits of Shariah training on an employee, majority of respondents were found in consensus with Shariah training to improve and enhance employees’ performance.
5. Discussion & Conclusion

The study intended to explore the impact of Shariah training on Islamic banking employees in Pakistan. The results provided an insight into individual experiences of Islamic banking employees working at different levels and in different capacities. Their experiences led this research to draw few themes out of many valuable points. These themes stimulated curiosity to probe and explore further about the current phenomenon of Shariah training and its impact on employees. A careful data analysis revealed that employees working in Islamic banking sector of Pakistan are well aware and considerably exposed to Shariah training. However, their attitude towards Islamic banking is not productive –what they perceived from Islamic banking operations (Dusuki, 2008). Further, they considered Shariah training as a backbone of an Islamic bank that is aimed to clarify doubts and reservations in employees’ mind. On the contrary, they viewed it not adequate to improve their perception of Islamic banking. Similarly, a majority of employees agreed on basic level of training that should be provided to every employee irrespective of its conventional or Shariah background that is considerably aligned with previous findings (Dewa & Zakaria, 2012). They expressed it as a step by step approach for learning and development of employees – basic first, extensive later.

However, the impact of Shariah training revealed some interesting viewpoints – although a majority agreed on few points, some argued differently in different perspective. Expressing their thoughts on how Shariah training can affect an employee, majority of the respondents agreed on Shariah training to improve employees’ motivation towards work and commitment towards the organization. Similarly, an increased occupational commitment of Islamic banking employees, improvement their attitude towards work and performance were some points on which a consensus was reached in general.

The findings of the current study contribute significantly to the body of knowledge which can ultimately be beneficial for management, Islamic banking practitioners as well as other stakeholders. The results drawn provide an insight to Shariah department to launch effective and regular Shariah training programs that will not only make employees to serve better their organizations but Islamic banking industry as well in terms of earning more repute and market share. Employees at the same time will perform better that will enhance service quality of Islamic banks and increased occupational and organizational commitment will serve as major tool to reduce employee turnover in Islamic banks in Pakistan.

Although the findings indicate a valuable approach through which Islamic banks can raise their service standards and employee performance, some limitations impeach the generalizing of the study. The sample taken for the study represents three Islamic banks out of five which can limit the responses and a better picture of Islamic banking industry cannot be portrayed. Similarly, the study explored Shariah training in particular while many other areas of Islamic banking sector in Pakistan were left unaddressed, that can be studied further in future.

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References

Al-Quran, Chapter 3, Al-Baqara, verse 278-279


Exploring the Impact of Shariah Training on Islamic Banking......


Liquidity Determinants of Islamic and Conventional Banks

By
Oussama Gafrej
Mouna Boujelbene Abbes

Abstract
This paper investigates the impact of specific banking factors and macroeconomic factors on banks’ liquidity of Islamic and conventional banks using generalized least squares (GLS). We show that Islamic banks hold more liquidity, can absorb the excessive withdrawal of funds and can pay its shorter maturity obligations better than conventional banks for the period from 2006 to 2013. For Islamic Banks, we found a positive and significant influence of past liquidity, return on assets and capital to total assets ratio on banks’ liquidity. Also, we found a negative and significant influence of size to banks’ liquidity. The loan loss reserves to gross loans ratio and the inflation rate have a positive and insignificant impact on liquidity, whereas the age has a negative and insignificant impact on liquidity. While the results of growth of loans, growth of gross domestic product and deposit interest rate are ambiguous. On the other hand, for conventional banks we found a positive and significant influence of past liquidity and return on assets on banks’ liquidity. Also, we found a negative and significant influence of capital to total assets ratio, growth loans, size, age and inflation rate on banks’ liquidity. The deposit interest rate has a positive and insignificant impact on liquidity. On the contrary, the growth of gross domestic product has a negative and insignificant impact on liquidity. While, the result of loan loss reserves to gross loans ratio is ambiguous.

Keywords: Banks’ liquidity, Islamic Banks, Conventional Banks, specific factors, macroeconomic factors.

Authors: Oussama Gafrej, Ph.D. student, Management Science-Finance, Faculty of Economics and Management of Sfax, University of Sfax, Sfax, Tunisia.
Mouna Boujelbene Abbes: Assistant Professor of Finance, Faculty of Economics and Management Of Sfax, University of Sfax, Sfax, Tunisia.
E-Mail: Corresponding author: oussama.gafrej01@gmail.com
1. Introduction

The last few years have seen a remarkable growth in the Islamic banking industry due to the religious principles and the wealth held by Muslims. In particular, the annual growth rate of its assets is significantly higher than conventional counterparts. Additionally, it is worth noting that the Islamic banking system is based on ethical and religious principles which differs from the conventional banking system, namely the prohibition of interest “Riba”, “Gharar” excessive uncertainty and gambling “Maisir”, the profit loss sharing, the necessity of a tangible asset and the prohibition of investing money in some activities which are harmful to society. These principles encourage people to make efforts to earn money, share the profits, bear the potential losses, give great importance to the growth of the economy and exclude any form of cheating, bribery, procrastination, speculation and exploitation. The practical application of these principles permits the emergence of some financial products actually used by the Islamic banking which can satisfy the preferences and the financial needs of investors and clients.

Risks in the bank are considered as a probability of loss caused by independent or dependent vulnerabilities, which develop gradually and might even reach a crisis. Jerome P.M.P Thijs (2011) defines banking risk as an “uncertain future events that could influence the achievement of the bank’s objectives, including strategic, operational, financial and compliance objectives.” Theoretically speaking, the nature of risks in Islamic banking differs from the conventional one due to the profit loss sharing principle and the necessity of a tangible asset. Therefore, the Islamic banks are facing not only the risks common to the entire banking sector, but also the specific risks inherent to its character. Particularly, the shortage of liquidity may quickly turn into solvency problems nearly in all banks. Liquidity Risk appears from the nature of banking activities which is taking deposits ordinary on shorter maturity for providing financing on medium and longer maturity. Therefore banks may be unable to repay short-term debts whereas their assets are on long term (mismatch maturity). Also the lack of confidence between banks and bank with central bank may cause various problems like the difficulty of access to intra bank market or central bank funding. Moreover, liquidity risk appears from the internal factors like instability of funding sources.

Several researchers have focused on the specific causes of liquidity in Islamic banks, Salman Sayed Ali (2004), Mohamed Helmy (2013) and Sabri Mohamed (2014) are some examples. Hence, it is essential for banks to manage their liquidity for reducing the potential loss of various problems like bankruptcies and huge economic losses.

The main objective of this article is to investigate the specific and macroeconomic factors that influence liquidity in Islamic and conventional banks. Also, it aims to analyze the evolution of the liquidity position within Islamic banking compared to the conventional one.

This paper is organized as follows: section 1 presents the literature review concerning the comparative study in the liquidity situation and the liquidity determinants of Islamic and conventional banks. Section 2 presents the data, the research methodology and the hypotheses. Section 3 analyses the research findings of the liquidity risk determinants. Finally, a conclusion is drawn to provide principal results and to make suggestions for future research.
2. Literature review

Some researches in the recent years focused on a comparative study in the liquidity risk. Salman Sayed Ali (2013) studied the liquidity situation in the banking sector for the time period 2000 - 2009. He used three measures which are: liquid assets to total assets ratio, financing to deposit ratio and maturity imbalance of assets and liabilities. The study found that Islamic banks have more liquidity than conventional banks mostly during the crisis period. In addition, Usman and Khan (2012) evaluated the performance of conventional and Islamic banks in Pakistan during the crisis period. The study showed that Islamic banks are more efficient and have higher liquidity than conventional ones. Moreover, Islam and Chowdhury (2006) focused on a comparative study between an Islamic bank and a conventional bank in Bangladesh, the study measured short-term and long-term liquidity positions by using the period from 2003 to 2006. The results suggested that the Islamic bank holds short-term and long-term assets for satisfying the short and long-term liabilities more than the conventional bank.

Several researches discuss the liquidity determinants of Islamic and conventional banks. Farhan, Ali and Sadaqat (2011) studied a sample of 6 Islamic banks and 6 conventional banks for the period of four years from 2006 to 2009. This study concludes positive and significant relation between liquidity and capital adequacy ratio in conventional banks. In contrast return on assets has a significant relation with liquidity in Islamic banks. Vodova (2011) focused on liquidity determinants in Hungarian banks from the period of 2001 to 2010. The result demonstrated that capital adequacy, interest rate and profitability have a positive impact on liquidity risk. Whereas, the size of banks, interest margin, monetary policy and the interest of interbank transaction have a negative impact on liquidity risk. While the relationship between gross domestic product and liquidity risk is ambiguous.

In addition, Naveed et al. (2011) found that the liquidity risk of Islamic banks in Pakistan has a significant relationship with leverage and tangibility. According to Oehler and Alman (2012) the liquidity risk in Islamic banks is positively determined by the size of bank and negatively influenced by the capitalization of the bank. Considering a sample of 3 Islamic Banks and 3 conventional Banks in the United Kingdom (UK) for the period of 2007 to 2011, Abdulle (2013) found that liquidity risk in the UK has a positive relationship with net working capital (NWC), size, and capital adequacy ratio (CAR) and is negatively related with return on equity (ROE) and return on assets (ROA) for Islamic and conventional banks.

A study conducted by Sulaiman, Taquiddin and Samsudin (2013) showed that the liquidity of Islamic banks in Malaysia has a significant relationship with profits, total of financing, total assets and macroeconomics factors. Ben Mousa (2015) studied the determinants of liquidity in 18 banks in Tunisia for the period of 2000 to 2010. The empirical results showed that the bank’s performance, equity to total asset ratio, rate of gross domestic product, rate of inflation and delayed liquidity have a significant impact on Tunisian banks’ liquidity. Moreover, Ben Jedidia and Hamza (2015) studied a sample of 60 Islamic banks in the Middle East and North Africa countries (2004 to 2012). The study showed that there is a negative and significant relationship between the bank’s profitability, the capital adequacy ratio, the investment ratio and the liquidity risk. The
empirical study of Ghenimi and Omri (2015) investigated the liquidity risk determinants in 11 Islamic banks and 33 conventional banks for the period from 2006 to 2013. The result indicated that the majority of factors included have a significant impact with liquidity risk in Islamic and conventional banks.

3. Data, variables and research hypotheses

3-1 Data

The data of this study cover Islamic and conventional banks in Islamic countries. We retain two types of variables which are the bank specific and the macroeconomic factors. The bank specific data are extracted from Bank scope data base. While, the macroeconomic data are obtained from the International Monetary Fund (IMF). Our sample contains 196 banks in which 86 are Islamic banks and 110 are conventional banks from 20 countries, covering the period from 2007 to 2013.

Table 1 presents the number of Islamic and conventional banks by country.

<table>
<thead>
<tr>
<th>Country</th>
<th>Islamic banks</th>
<th>Conventional banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tunisia</td>
<td>1</td>
<td>11</td>
</tr>
<tr>
<td>Algeria</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Iran</td>
<td>14</td>
<td>0</td>
</tr>
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<td>Qatar</td>
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<td>6</td>
</tr>
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<td>Palestine</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Yemen</td>
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<td>1</td>
</tr>
<tr>
<td>Bahrain</td>
<td>16</td>
<td>10</td>
</tr>
<tr>
<td>Iraq</td>
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</tr>
<tr>
<td>Sudan</td>
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<tr>
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<tr>
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<tr>
<td>Kuwait</td>
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</tr>
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<td>Oman</td>
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<td>Brunei</td>
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</tr>
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</tr>
<tr>
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<td>2</td>
</tr>
<tr>
<td>Turkey</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>86</td>
<td>110</td>
</tr>
</tbody>
</table>

3.2 Variables and research hypotheses

3-2-1 Dependent variable

The dependent variable in this study is banks’ liquidity. We use two measures as a proxies of banks’ liquidity, which are the ratios of liquid assets to total assets and liquid assets to deposits and short term funding.
- **The Liquid Assets to Total Assets Ratio**: it articulates the ability of banks to absorb the liquidity shock. The high liquidity ratio indicates that bank holds more liquid assets in their balance sheet and can absorb the excessive withdrawal of money.

The liquid assets is measured as follows:

\[
\text{Liquid Assets} \div \text{Total Assets} \times 100 \quad (1)
\]

- **The Liquid Assets to Dep & ST Funding ratio**: this ratio gives a picture of the liquidity position and articulates the ability of banks to pay its depositors. Higher liquid assets /deposits and short term funding indicates that the bank can pay its shorter maturity obligations.

The liquid assets to Dep & ST Funding ratio is measured as follows:

\[
\text{Liquid Assets} \div \text{Deposits and Short Term Funding} \times 100 \quad (2)
\]

According to Ben Moussa (2015) the past liquidity has a positive impact on bank’s liquidity. Hence, we will test the following hypothesis:

H1: There is a positive relationship between bank’s liquidity and bank’s liquidity at time t-1.

**3-2-2 Independent variables**

We have used 9 variables as liquidity determinants of Islamic and conventional banks. The variables selected are divided into two groups: specific banking factors (Return on Assets, capital to total assets ratio, size of bank, growth loans, loss loan reserves to gross loans ratio and age ) and macroeconomic factors (gross domestic product, inflation and Deposit Interest Rate).

a. **Specific banking factors**

The **size of the bank**: The relation between the size of the bank and liquidity risk has been the object of few studies. The research by Naveed et al. (2011) found insignificant relation between size and liquidity risk in a study on 6 banks in Pakistan. Also, Ghenimi and Omri (2015) showed that size has a negative impact on liquidity for Islamic banks, while in conventional banks size has a positive impact. In a study on Czech banks, Vadova (2011) found that the influence of the size on the liquidity is ambiguous. Oehler and Alman (2011) show that there is a negative impact between liquidity transformation and small Islamic banks. By using the results of these studies the second hypothesis can be formulated as follows:

H2: There is a negative relationship between bank’s liquidity and size of the bank.

The size of the bank is calculated by the following formula:

\[
\log (\text{Total Assets}) \times 100 \quad (3)
\]

**Return on Assets**: return on assets is considered as a measure of a bank’s performance and profitability. This ratio gives a picture of how the bank uses their assets
for generating more profits, and is calculated as the ratio of net income (after tax) to total assets. Concerning the effect or return on assets to liquidity, Sulaiman et al. (2013) found that ROA is positively related to liquidity for 17 Islamic banks in Malaysia. In addition, Ben Jdidia and Hamza (2015), showed that ROA is positively related to liquidity for 60 Islamic banks in the Middle East and North African countries. On the other hand, for a sample of 18 commercial banks in Tunisia, Ben Moussa (2015) found that ROA has a significant impact on liquidity. The same result was found by Vadova (2011) for commercial banks in Hungary. In accordance with these findings, the third hypothesis is:

H3: There is a positive relationship between bank’s liquidity and return on assets.

The Return on Assets is calculated by the following formula:

\[
\text{Net Income After Tax} \times \frac{100}{\text{Total Assets}}
\]

\[\text{(4)}\]

**Growth Loans**: loans are a key focus and an essential activity for banks and are considered as a fundamental source to serve its purpose which is providing financing and generate higher profits. Higher amount of loans indicates that banks hold more illiquid assets in their balance sheet. That means decreasing bank liquidity and increasing liquidity risk. Murithi (2010) examined the relationship between banks liquidity and loan growth in Kenyan banks. He found that growth of loans has an explaining positive impact on liquidity risk. Tesfaye (2012) analyzed the determinants of banks liquidity in Ethiopia, he found that there is a negative relationship between liquidity and growth loans. Usually there is a negative link between growth loans and banks liquidity. Therefore, in this study we will test the following hypothesis:

H4: There is a negative relationship between bank’s liquidity and growth of loans.

The Growth Loans is calculated by the following formula:

\[
\frac{\text{Loans (t)} - \text{Loans (t - 1)}}{\text{Loans (t - 1)}} \times 100
\]

\[\text{(5)}\]

**Capital to Asset Ratio**: it measures the capacity of the bank to cover the loss assets resulting from inadequate financial operations. Higher capital to asset ratio indicates that a bank’s capital represents a large proportion in their balance sheet. Farhan, Ali and Sadaqat (2011) found that in conventional banks CAP has a positive influence on liquidity risk. In addition, Iqbal et al. (2015) showed that CAP has a negative and significant impact on liquidity risk for commercial Banks in Pakistan. Ghenimi and Omri (2015) found that CAP has a significant and positive relationship with the liquidity risk for 11 Islamic banks and 33 conventional banks for the period of 2006 to 2011. The work of kochubey and kowolczyk (2014) focused on capital, bank liquidity and risk in the United States commercial banks. They used capital to asset ratio as a proxy to measure banks capital among other ratios. The results showed that banks increase their capital to asset ratio during liquidity risk period. As a result, there is a positive relationship between bank capital and bank liquidity. Focusing on the results of kochubey and kowolczyk (2014) the fifth hypothesis can be formulated as follows:
H5: There is a positive relationship between bank’s liquidity and capital to total assets ratio.

The capital to asset ratio is measured as follows:

\[
\frac{\text{Capital}}{\text{Total Assets}} \times 100 \quad (6)
\]

*Loan loss reserves to gross loans ratio (LLR)*: the loan loss reserve is an amount held by the bank in order to cover potential default risk of gross loans. The LLR ratio is used by banks to measure credit risk and the quality of banks asset. The higher LLR ratio indicates that banks may confront more future losses. Alman and Oehler (2012) analyze the relation between LLR ratio and liquidity transformation in Islamic banks. This study found that liquidity transformation is negatively determined by LLR ratio. In particular, using the result of Alman and Oehler (2012), the sixth hypothesis of this research is:

H6: There is a positive relationship between bank’s liquidity and LLR ratio.

The loan loss reserves to gross loans ratio is measured as follows:

\[
\frac{\text{Loan Loss Reserve}}{\text{Gross Loans}} \times 100 \quad (7)
\]

*Age*: Ahmad et al. (2011) found that age has a negative and significant effect on banks’ liquidity in Islamic banks of Pakistan. In accordance with this empirically result, we can expect that age has a negative effect on banks’ liquidity. Therefore the seventh hypothesis of this research is:

H7: There is a negative relationship between bank’s liquidity and bank’s age.

b) *Macroeconomic factors*

*Growth of Gross Domestic Product (GDP)*: it measures the economic activity growth in each country and is considered as an external factor that influences the liquidity of a bank. According to Ben Jedidia and Hamza (2015) in the period in which the economy grows, banks decide to increase their long term maturity investments and decrease their liquid assets which leads to a negative impact on banks’ liquidity. Ghenimi and Omri (2015) found that GDP growth has a negative influence on liquidity in Islamic banks, while, it has a positive impact on liquidity in conventional banks. On the other hand, Tesfaye (2012) showed that GDP growth has a positive and insignificant impact on liquidity for commercial banks in Ethiopia. In contrast, Ben Moussa (2015) revealed that GDP growth has a significant impact on Tunisian bank liquidity. In accordance with the results of Ghenimi and Omri (2015) and Tesfaye (2012), we will test the following hypothesis:

H8: There is a positive relationship between bank’s liquidity and gross domestic product.

*Inflation rate*: The rate of inflation can affect the banks’ liquidity through the non-repayment of loans and the discouragement of the customers for saving their money
(Nyakira Audo (2014)). Ben Moussa (2015) studied the relationship between inflation and liquidity in Tunisian context. The results of this study showed that inflation positively affects the liquidity. According to Nyakida Audo (2014) inflation is not a significant variable that has an impact on commercial banks in Kenya. On the other hand, Ghenimi and Omri (2015) showed that the inflation rate has a positive impact on liquidity for conventional and Islamic banks in the gulf countries. In accordance with these findings, the ninth hypothesis:

H9: There is a positive relationship between bank’s liquidity and Inflation.

Deposit interest rate: A conventional bank applies the deposit interest rate for determining the remuneration of deposits. On the other hand, the hard competition and the unfavorable environment of Islamic Institutions encourage customers to remove their funds when the rate of return in Islamic banks is less than conventional counterparts. That is why it is necessary for Islamic banks to adapt with their environment by considering deposit interest rate as a reference in order to determine the rate of return. For this research, we use deposit interest rate as a proxy of displaced commercial risk in order to measure the relation between displaced commercial risk and bank liquidity. In a study on Hungarian banks Vodova (2011), found that interest rate has a positive impact on banks’ liquidity for the period from 2001 to 2010. For Islamic banks, no research has studied the relation between the deposit interest rate and liquidity risk. But there are limited empirical studies which studied the relation between the deposit interest rate and the displaced commercial risk. For example, Arshad et al. (2014) found that the displaced commercial risk is significantly influenced by deposit interest rate for Islamic banks in Malaysia.

By using these empirical results, we will test the following hypothesis:

H10: There is a positive relationship between bank’s liquidity and deposit interest rate.

4- Models Specification

To investigate the liquidity determinants for Islamic and conventional banks, we estimate the following regressions:

**Model 1**

\[
LATA_{i,t} = \alpha_0 + \alpha_1 LATA_{i,t-1} + \alpha_2 ROA_{i,t} + \alpha_3 SIZE_I_{i,t} + \alpha_4 CAP_{i,t} + \alpha_5 GL + \alpha_6 LLR_{i,t} + \alpha_7 AGE_i + \alpha_8 GDP_{i,t} + \alpha_9 INF_{i,t} + \alpha_{10} DIR_I_{i,t} + \epsilon_{i,t}
\]

**Model 2**

\[
LATA_{i,t} = \alpha_0 + \alpha_1 LATA_{i,t-1} + \alpha_2 ROA_I_{i,t} + \alpha_3 SIZE_I_{i,t} + \alpha_4 CAP_{i,t} + \alpha_5 GL + \alpha_6 LLR_{i,t} + \alpha_7 AGE_i + \alpha_8 GDP_{i,t} + \alpha_9 INF_{i,t} + \alpha_{10} DIR_I_{i,t} + \epsilon_{i,t}
\]

**Where:**

\( t = 1, 2 \ldots T \) (6 years in this case): \( i = 1, 2 \ldots N \) (number of banks: 86 Islamic banks and 110 Conventional Banks).

\( \alpha_0 = \) constant coefficient.
α_i = coefficient of independent variables.
LATA = Liquid Assets to Total Assets.
LATD = Liquid Assets / Dep & ST Funding.
LATA_{it-1} = Liquid Assets to Total Assets for bank i at time t-1.
LATD_{it-1} = Liquid Assets / Dep & ST Funding for bank i at time t-1.
ROA = Return on Assets.
SIZE = size of bank.
CAP = Capital to Total assets.
GL = Growth Loans.
LLR = loss loan reserves to gross loans
AGE = age
GDP = gross domestic product.
INF = rate of inflation.
DIR = Deposit Interest Rate.
ε_{i,t} = the random error.

5- Empirical results

5-1- Liquidity positions

In the following, we will analyze the liquidity positions of Islamic and conventional banks both by the liquid assets to total assets ratio and the liquid asset to deposits and short term funding ratio.

5-1-1- Liquid assets to total assets ratio

Figure 1: Average of Liquid Assets to Total Assets ratio for Islamic and Conventional Banks
Figure 1 provides the average of liquid assets to total assets for Islamic and Conventional banks during the period from 2006 to 2013. We show that Islamic banks liquidity was higher than that of conventional banks. We also show that even during the global financial crisis, Islamic banks hold more liquid assets. For example, at the end of the year 2008, we show that the LATA was 27.74 for Islamic banks and 24.09 for conventional banks. In the period from 2009 to 2013, an important difference in the average of the liquid assets ratio is noted, especially in 2013 which was 23.94 percent for Islamic banks and 18.39 percent for conventional banks with a difference equal to 5.55 percent.

5-1-2- Liquid assets to total deposits and short-term funding

Figure 2: Average of Liquid assets to total deposits and short-term funding ratio for Islamic and Conventional Banks

Figure 2 plots the evolution of the liquidity position by the average of liquid assets to deposits and short term funding ratio. We show that the liquidity position in Islamic banks is improved. In 2008, this ratio shows the greatest values for Islamic banks 72.17 percent.

During the sample period, the proposition of liquid assets to deposits and short term funding was quite higher for Islamic banking suggesting that the position of liquidity and ability to pay the shorter maturity obligations is superior in Islamic banks.

5-2- Descriptive Statistics

Table 2 presents descriptive analysis for Islamic and conventional banks.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Observations</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Minimum</td>
</tr>
<tr>
<td><strong>Panel A: Islamic Banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LATA</td>
<td>467</td>
<td>25.7644</td>
<td>15.0414</td>
</tr>
<tr>
<td>LATD</td>
<td>467</td>
<td>62.0618</td>
<td>84.9575</td>
</tr>
<tr>
<td>ROA</td>
<td>467</td>
<td>1.6569</td>
<td>5.0665</td>
</tr>
<tr>
<td>CAP</td>
<td>467</td>
<td>26.2511</td>
<td>25.2886</td>
</tr>
<tr>
<td>GL</td>
<td>467</td>
<td>24.0622</td>
<td>66.1497</td>
</tr>
<tr>
<td>SIZE</td>
<td>467</td>
<td>6.41953</td>
<td>0.8278</td>
</tr>
<tr>
<td>LLR</td>
<td>467</td>
<td>5.36102</td>
<td>6.7279</td>
</tr>
</tbody>
</table>
Concerning the two ratios used to measure the bank liquidity (LATA and LATD), the table indicates that the mean of LATA for Islamic banks is 25.7644 percent and for conventional banks is 23.2779 percent which means that Islamic banks kept more liquid assets than conventional banks. The mean of LATD for Islamic banks was 62.0618 percent. While for conventional banks it was 31.2779 percent. From this analysis, it is clear that liquid asset to deposits and short term ratio is higher in Islamic banking. But the variability of this ratio which is measured by standard deviation is high in Islamic banking suggesting the risky aspect of Islamic instruments. According to the table, the arithmetical averages of the bank characteristic factors indicate that the capacity to generate profit, which was measured by ROA, the capacity to cover the loss assets which, measured by CAP, the holding of illiquid assets which measure by GL and the credit risk position which measured by LLR is higher in Islamic banks compared to conventional ones. But the standard deviation is high on Islamic banking. These results can be explained by the tremendous growth of Islamic finance. Concerning, the arithmetical averages of the size of the bank and the age are higher for conventional banks.

5-3- Test of Hausman

The Hausman test compares the variance-covariance matrix of the two estimators (fixed and random) by calculating the distribution statistics of chi square:

$$\text{Chi}^2(2) = (\hat{b} - \hat{F})'(V_{\hat{b}} - V_{\hat{F}})'(-1)(\hat{b} - \hat{F})$$ (10)

The null hypothesis (H0) assumes the presence of random effect, while the alternative hypothesis assumes the presence of fixed effect. H0 is accepted if the probability gives by

Hausman test is greater than 5%. Contrary, H0 is rejected if the probability is less than 5%.

Table 3 presents the Hausman test for Islamic and conventional banks.
The results indicate that the Model 1 and Model 2 for conventional and Islamic banks are fixed with (prob> chi2 = 0.0000).

**5-4- Heteroscedasticity Test**

According to Williams (2015), heteroscedasticity can bias the standard errors which lead to bias the statistical tests. The null hypothesis (H0) assumes the presence of homoscedasticity, while the alternative hypothesis assumes the presence of heteroscedasticity.

Table 4 presents the heteroscedasticity test by using the Breusch Pagan test.

<table>
<thead>
<tr>
<th>Models</th>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model 1</td>
<td>32.73</td>
<td>85.10</td>
</tr>
<tr>
<td></td>
<td>(0.0000)</td>
<td>(0.0000)</td>
</tr>
<tr>
<td>Model 2</td>
<td>610.56</td>
<td>250.36</td>
</tr>
<tr>
<td></td>
<td>(0.0000)</td>
<td>(0.0000)</td>
</tr>
</tbody>
</table>

We find that (prob > chi2 = 0.0000). As a result, there is a heteroscedasticity problem with the two models of Islamic and conventional banking. In order to solve this problem we will have to use generalized least squares (GLS).

**5-5- Multicollinearity Test**

The variance inflation factor (VIF) permits to detect the existence of multicollinearity by calculating the degree of multicollinearity between each explanatory variable with all other explanatory variables in our models. Table 5 presents the variance inflation factor in both models.

<table>
<thead>
<tr>
<th>Model 1</th>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variables</td>
<td>VIF</td>
<td>1/VIF</td>
</tr>
<tr>
<td>LATA t-1</td>
<td>1.12</td>
<td>0.8964</td>
</tr>
<tr>
<td>ROA</td>
<td>1.06</td>
<td>0.9423</td>
</tr>
<tr>
<td>CAP</td>
<td>1.48</td>
<td>0.6767</td>
</tr>
<tr>
<td>GL</td>
<td>1.12</td>
<td>0.8964</td>
</tr>
<tr>
<td>SIZE</td>
<td>1.50</td>
<td>0.6645</td>
</tr>
<tr>
<td>LLR</td>
<td>1.10</td>
<td>0.9121</td>
</tr>
<tr>
<td>AGE</td>
<td>1.25</td>
<td>0.7977</td>
</tr>
<tr>
<td>DIR</td>
<td>1.92</td>
<td>0.5215</td>
</tr>
<tr>
<td>GDP</td>
<td>1.17</td>
<td>0.8550</td>
</tr>
<tr>
<td>INF</td>
<td>2.00</td>
<td>0.4989</td>
</tr>
<tr>
<td>Mean VIF</td>
<td>1.37</td>
<td></td>
</tr>
</tbody>
</table>
According to Reyna (2007) there are no multicollinearity problems when a VIF coefficient is inferior to 10 or 1/VIF is superior to 0.10. The results favor that there are no multicollinearity problems in the models for Islamic and conventional banks.

5-6- Regression analysis

Table 6 presents the estimation results of equations 8 and 9 for Islamic Banks and Conventional Banks.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>VIF</td>
<td>1/VIF</td>
</tr>
<tr>
<td>$LATD_{t-1}$</td>
<td>1.56</td>
<td>0.6399</td>
</tr>
<tr>
<td>$ROA$</td>
<td>1.08</td>
<td>0.9274</td>
</tr>
<tr>
<td>$CAP$</td>
<td>2.00</td>
<td>0.4993</td>
</tr>
<tr>
<td>$GL$</td>
<td>1.08</td>
<td>0.9281</td>
</tr>
<tr>
<td>$SIZE$</td>
<td>1.45</td>
<td>0.6875</td>
</tr>
<tr>
<td>$LLR$</td>
<td>1.11</td>
<td>0.9047</td>
</tr>
<tr>
<td>$AGE$</td>
<td>1.25</td>
<td>0.7983</td>
</tr>
<tr>
<td>$DIR$</td>
<td>1.92</td>
<td>0.5217</td>
</tr>
<tr>
<td>$GDP$</td>
<td>1.17</td>
<td>0.8549</td>
</tr>
<tr>
<td>$INF$</td>
<td>2.00</td>
<td>0.5003</td>
</tr>
<tr>
<td>Mean VIF</td>
<td>1.46</td>
<td></td>
</tr>
</tbody>
</table>

According to Reyna (2007) there are no multicollinearity problems when a VIF coefficient is inferior to 10 or 1/VIF is superior to 0.10. The results favor that there are no multicollinearity problems in the models for Islamic and conventional banks.

Dependent variables: $LATA$, $LATD$

Mean VIF

Model 2

Variables | VIF | 1/VIF | VIF | 1/VIF |
----------|-----|-------|-----|-------|
$LATA_t-1$ | 1.56 | 0.6399 | 1.23 | 0.8156 |
$ROA$ | 1.08 | 0.9274 | 1.19 | 0.8432 |
$CAP$ | 2.00 | 0.4993 | 1.43 | 0.6983 |
$GL$ | 1.08 | 0.9281 | 1.07 | 0.9327 |
$SIZE$ | 1.45 | 0.6875 | 1.28 | 0.7830 |
$LLR$ | 1.11 | 0.9047 | 1.16 | 0.8634 |
$AGE$ | 1.25 | 0.7983 | 1.12 | 0.8953 |
$DIR$ | 1.92 | 0.5217 | 1.38 | 0.7248 |
$GDP$ | 1.17 | 0.8549 | 1.03 | 0.9719 |
$INF$ | 2.00 | 0.5003 | 1.43 | 0.7006 |
Mean VIF | 1.46 | | 1.23 | |

*** Significant at 1 % level. ** Significant at 5 % level *** Significant at 10 % level.
According to the estimation results of Islamic banks, the past liquidity has a positive and significant relation with the banks’ liquidity at 1% level. The coefficient sign of past liquidity in both models is in line with hypothesis 1. The size of the bank is statistically significant at the 5% level in model 1 and insignificant in model 2 with a negative sign, the result of model 1 is in line with our assumption. The ROA ratio has the positive significant relation with the banks’ liquidity at 10% level in both models and consistent with hypothesis 3. The GL has the negative insignificant relation with the banks’ liquidity in model 1 and the positive insignificant relation in model 2. The CAP ratio has a positive significant relation with the banks’ liquidity at 10% and 1% level in model 1 and model 2 respectively and compatible with hypothesis 5. The LLR ratio has the positive insignificant relation with the banks’ liquidity. The bank’s age has a negative insignificant relation with the banks’ liquidity. In addition to that the DIR and the GDP have a negative insignificant relation with the banks’ liquidity in model 1 and a positive insignificant relation in model 2. The INF rate has the positive insignificant relation in both models. Concerning the estimation results of conventional banks, we find that the past liquidity has a positive significant relation with the banks’ liquidity at 1% level. This result is in line with hypothesis 1 in both model 1 and model 2. Results also show negative significant relation with the banks’ liquidity at 10% level in model 1 and at the 1% level in model 2, this result is consistent with hypothesis 2. The ROA ratio has a positive significant relation with the banks’ liquidity at 1% level and consistent with hypothesis 3. The GL has a negative significant relation with the banks’ liquidity at 10% level in model 1 and at the 1% level in model 2. This result corresponds with our expectation. The CAP ratio has a negative significant relation with the banks liquidity at 10% level in both models, this negative significant relation is not as per our expectation. The LLR ratio is statistically insignificant related to the banks’ liquidity with a positive sign in model 1 and a negative sign in model 2. The bank’s age has a negative significant relation with the banks’ liquidity in both models. This result is consistent with hypothesis 7. Regarding GDP, it has a negative insignificant relation with the banks’ liquidity in both models. The INF rate has a negative significant relation with the banks’ liquidity at 10% level in model 1 and it has the negative insignificant relation in model 2. Finally, the DIR has a positive insignificant relation with the banks liquidity in both models. The outcome of macroeconomics factors is not consistent with our expectation; the only exception is the inflation rate. Table 7 presents the accepting or the rejecting of the hypothesis, the expected and the observed impact.

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Expected Impact</th>
<th>LATA</th>
<th>LATD</th>
<th>LATA</th>
<th>LATD</th>
<th>IB</th>
<th>CB</th>
</tr>
</thead>
<tbody>
<tr>
<td>LATA t-1</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>Accepted</td>
<td>Accepted</td>
</tr>
<tr>
<td>LATD t-1</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Ins</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Sig</td>
<td>Accepted</td>
<td>Accepted</td>
</tr>
<tr>
<td>SIZE</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Ins</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Sig</td>
<td>Accepted</td>
<td>Accepted</td>
</tr>
<tr>
<td>ROA</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>Accepted</td>
<td>Accepted</td>
</tr>
<tr>
<td>GL</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Ins</td>
<td>(+)&amp;Ins</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Sig</td>
<td>Rejected</td>
<td>Accepted</td>
</tr>
<tr>
<td>CAP</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Sig</td>
<td>(-)&amp;Sig</td>
<td>(-)&amp;Sig</td>
<td>Accepted</td>
<td>Rejected</td>
</tr>
<tr>
<td>LLR</td>
<td>(+)&amp;Sig</td>
<td>(+)&amp;Ins</td>
<td>(+)&amp;Ins</td>
<td>(+)&amp;Ins</td>
<td>(-)&amp;Ins</td>
<td>Rejected</td>
<td>Rejected</td>
</tr>
</tbody>
</table>
Conclusion

The objective of this paper is to analyze the evolution of liquidity in Islamic and conventional banks. Moreover, it aims to examine the impact of internal and macroeconomic factors on the liquidity situation of conventional and Islamic banks.

First, we analyzed the evolution of liquidity situation which is measured by liquid assets to total assets ratio and liquid assets to total deposits and short term funding. The results showed that Islamic banks hold more liquidity, can absorb the excessive withdrawal of funds and can pay its shorter maturity obligations better than conventional banks for all years from 2006 to 2013. In addition, to ensure the liquidity stability of banks, we examined the impact of specific banking factors and macroeconomics factors on banks’ liquidity. The results highlight that past liquidity has a positive and significant effect on liquidity ratios for Islamic and conventional banks and consistent with the findings of Ben Moussa (2015). The impact of size on liquidity is negative and significant for Islamic banks when liquidity is measured by liquid assets to total assets ratio. On the other hand, for conventional banks the results show that size is negatively and significantly related to banks’ liquidity for the two models. The findings are in line with the empirical results of Oehler and Alman (2011). The bank performance, measured by return on assets ratio, has a positive impact on liquidity of Islamic and conventional banks. This result is found by several previous studies. Also, for Islamic banks the growth of loans has a negative relationship with liquidity measured by liquid assets to total assets ratio. While, the liquidity measured by liquid assets to total deposits and short term funding ratio has a positive relationship with growth loans. On the other hand, our findings are similar to Tesfaye (2010), we found a significant and negative relationship between liquid assets to total deposits and short term funding ratio and growth loans. In addition, there is a positive and significant relationship between liquidity and capital to total assets ratio for Islamic banks in both models. On the other hand, we observe that liquidity and capital to total assets ratio are negatively significant in both models. This result confuses our expectation. For Islamic banking the finding suggests that there is a positive relationship between liquidity and loss loan reserves to gross loans ratio. Whilst, loss loan reserves to gross loans ratio is negatively and significantly related to liquidity for conventional banks. The results show that there is a negative relationship between the age of bank and liquidity for Islamic banks. Concerning the impact of age on liquidity for conventional banks, we find a negative and significant impact. Our findings are in line with the empirical results of Ahmad and al. (2011) and do not confirm our expectations. Furthermore, the results show that if we measure the liquidity with liquid assets to total assets ratio, the link between the liquidity of Islamic banks and gross domestic product is negative and if we measure the liquidity with liquid assets to total deposits and short term
funding ratio, the link between the liquidity and gross domestic product is positive. Therefore the influence of gross domestic product in Islamic banks is ambiguous. On the other hand, we found that gross domestic product has a negative, but no statistically significant impact on the liquidity of conventional banks. These results don’t confirm our expectations. But, it is compatible with Ghenimi and Omri (2015). The results show that the inflation rate registered a positive relationship with liquidity for Islamic banks in both models. On the other hand, we observe that liquidity and inflation are negatively and significantly related to liquidity measured by liquid assets to total assets ratio and when the liquidity is measured by liquid assets to total deposits and short term funding ratio the coefficient of the inflation is not significant and has a negative sign. The deposit interest rate which is used as a proxy for displaced commercial risk for Islamic banks has a positive impact on liquidity only when the liquidity is measured by liquid assets to total deposits and short term funding ratio. With regard to conventional banks, we found that there is a positive and insignificant relationship between liquidity and deposit interest rate. This result confirms our expectation and is compatible with the result of Vodova (2011). According to our findings, we can conclude that the conventional banks liquidity is more sensitive by specific banking factors than the liquidity for Islamic banks.

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Expounding the Relevance of Retirement Planning from the Primary Sources of the Shari’ah

By
Haneffa Binti Muchlis Gazalia and Nabil Bello

Abstract:

Purpose - This paper presents an introduction on retirement planning from the Islamic perspective. Most importantly, it points out the lessons of retirement planning from the Islamic primary sources, that is the Qur’an and the Hadith and also from the maqasid al-Shari’ah.

Design/methodology/approach – A secondary methodology is used for this study through library research by reviewing the concepts and processes of retirement planning from the Islamic perspective.

Findings – Although the concept of retirement planning is not found in Islamic literature, there are some verses in the Qur’an and hadith that show the importance of planning for future and taking measures against risks and uncertainties in life. The importance of planning is not solely for individuals alone but for their wives and children.

Limitation/implication – It is noted that there are limited studies on retirement planning from Islamic perspective. The paper also utilized conceptual approach without conducting empirical and statistical investigations.

Practical implication – The paper provides an insight on the importance of retirement planning and its relevance from the Shari’ah point of view. It is
essential for the policy makers and service providers to offer retirement products that comply with Shari'ah rulings.

**Originality** – This paper is the first attempt to discuss retirement planning through maslahah and Maqasid al-Shari'ahin order to encourage Muslim manage their wealth properly for the sake of obtaining al-falah in this world and in the hereafter.

**Keywords** – Islamic, retirement planning, Qur’an and Hadith, Maqasid al-Shari’ah

**Paper type** Conceptual paper

I. Introduction

Working individuals are generally responsible for their financial security and life after retirement. Retirement is defined as a stage in life where people are no longer active in the economic production. It is therefore pertinent for all working individuals to have a proper plan for their retirement. There are many reasons that hinder people to save for retirement such as changes in macroeconomic policy, medical expenses, children education, income, age, just to name a few (Mansor, Hong, Abu, & Shaari, 2015). Malaysia is like many other countries that undergo ageing population and longer life expectancy (Jamaludin & Gerrans, 2015) especially among women (Sapiri, Kamil, & Mat Tahar, 2012). The life expectancy of Malaysian residents upsurges every year. In 2015 for instance, the Department of Statistic Malaysia revealed that newborns are expected to live 74.8 years as compared to 74.1 years in 2010.

Most Malaysian employees are too dependent on defined contribution (DC) plans whereby the risk is directly borne by the individual employee since the government or employer shifts the retirement funds to individual fund members. In short the employee is responsible for his investment decisions (Jamaludin & Gerrans, 2015). There are two types of DC plans in Malaysia, which are: Government pension and Employees Provident Fund (EPF). Government servants may decide to go for Government pension and some may choose Employees Provident Fund (EPF) but for those in the private sector, it is compulsory for them to save in the EPF.

The past thirty years have seen rapid advances in the field of retirement studies. A number of researches have reported that poor retirement planning will lead to insufficient income in the golden years of individuals (Ibrahim, Isa, & Ali, 2012; Mansor, Hong, Abu, & Shaari, 2015). Also, most of the prior researches focus on retirement planning from the secular perspective. Hence, lack of retirement planning studies from Islamic perspective has been explored. However, some researches have been carried out on the role of religion towards savings (Haron & Wan Azmi, 2008) yet the study is not specifically from the context of retirement savings. Remarkably, Jamaludin & Gerrans (2015) discovered that religion and religious commitment is not a significant factors for EPF members in Malaysia for making investment decision particularly in unit trust for their retirement savings. What is still not yet clear is, how Islamic worldview perceives retirement planning? Is there any evidence from the Islamic primary sources that support the importance of retirement planning from Islamic point of view? Islam is more than a religion, it is a complete and comprehensive way of life in order to balance the way of
living. A system of law has been established in Islam that integrates all aspects of human society to bring happiness and peace to the believers. Islamic law aims to promote welfare (maslahah) and to prevent harm (mafsadah) of humankind (Ahmed, 2011).

Previous studies in the field of retirement have only focused on the key factors that determine retirement savings behavior. However, the researchers did not capture retirement planning from an Islamic perspective. There is paucity of literature on retirement planning studies that capture the lesson from the Holy Qur’an and Hadith. This paper aims to present an introduction to retirement planning from an Islamic perspective. Most importantly, the study points out the lessons of retirement planning from the Islamic primary sources that is Qur’an and Hadith.

II. Concept of Financial Planning

Nowadays, with the rapid changes in technologies, economics, politics and social environment it is complicated to have a comprehensive financial strategy that can enhance the individual way of living. Alternatively, in whatever terms people define a “good life”, they need to work on their financial goals and transform them into reality. This could only be achieved when people possess sound financial planning strategies.

Financial planning is a continuous process that addresses and develops an individual’s finances over time. The financial plan is not a single time process (Scott Brewster, 2015). Financial planning deals with an individual’s financial planning that indicates their personal financial goals. People need to have an effective financial plan to prepare for any circumstance. With an effective plan, people can accomplish their goals and grab any opportunity in the future. There is the need for financial planning due to the several factors such as the increase in life expectancy (Grace, Weaven, & Ross, 2010), types of workers, medical expenses, retirement policy (Fitri Mansor et al., 2015).

Personal financial planning is an ultimate way to attain financial objectives. This typical approach encompasses the efficient application of savings to accumulate funds, considering depreciation in value and losses for further consumption in the future. Therefore, managing financial need incorporates six main components, for instance tax planning, cash flow planning, investment, risk management, retirement planning and estate planning. As time goes by, personal financial planning products are becoming more sophisticated. Unfortunately, the rapid development of those products is not parallel with the ability of people to perform financial planning. Lusardi (2008) states that financial literacy is an important indicator for households to plan for their retirement. However, Bhramana et al. (2014) discovers that basic financial literacy is not a very strong predictor to retirement planning as compared to advanced financial literacy. They claim that, better knowledge in finance will lead to better retirement planning. Advanced financial literacy in their study was measured based on knowledge in segregating between stocks and bonds, the function of the stock market, risk diversification, the relationship between bond prices and interest rate. Many respondents were not able to answer advanced literacy questions due to the fact that advanced financial literacy is more complex and may delve into real financial knowledge. Therefore, it is important to exhaustively gauge the meaning of and identify the important elements in retirement planning.
III. Islamic Worldview of Financial Planning

Islamic finance is closely related to Islamic financial planning. In Malaysia, the development of Islamic financial planning is parallel to the conventional financial planning. Financial planning services in Malaysia aim to offer educational programs related to planning that suits individual needs according to their ethics and religious background (Shafii, Mohd. Yusoff, & Md. Noh, 2013). Muslims are restricted to the Shari’ah rulings in any financial activity, therefore, it is necessary to develop the curriculum that is able to cater for the demand of the Muslim population by considering their norms and aims of life. Islamic worldview was derived from the Holy Qur’an and Hadith (words and conduct of the prophet ﷺ). Financial planning is very important in securing one against hardship. Allah says in the Qur’an:

“He [Yusuf] said: You will plant for seven years consecutively; and what you harvest leave in its spikes, except a little from which you will eat. Then will come after that seven difficult [years] which will consume what you advanced [i.e., saved] for them, except a little from which you will store. Then will come after that a year in which the people will be given rain and in which they will press [olives and grapes].”

The verses above show the importance of planning; this is why they are known as planning verses. They highlight the significance of planning because an individual will face detrimental circumstance in life for instance death. The hardship is certain if that person does not have any proper planning, especially to their families. Therefore, planning is considered as a mode of preventing hardship. Financial planning not just solely signifies the form of worship to prevent the hardship, yet, al-falah can be obtained through proper planning. Al-falah means success in worldly life and hereafter(Shafii et al., 2013). The lessons to be learnt from the planning verses is that it is clear that people need to plan, consume wisely and save for their future.

Islamic scholars consider wealth as belonging to Allah. The humankind needs to utilize and consume wealth wisely. In the Holy Qu’ran, Allah says:

Believe in Allah and His Messenger and spend out of that in which He has made you successive inheritors. For those who have believed among you and spent, there will be a great reward. (Al-Hadeed, 57:7)

As a Muslim, man should admit that all things in this world belong to Allah and the wealth is under his care. A Muslim has to remember that he is accountable for any and all actions. In the hereafter, he will answer directly to Allah on how he manages the wealth in this world. Managing wealth for individual Muslims is a less complex process as compared to managing wealth in a large Muslim society. However, to practice wealth management, a person needs to have adequate knowledge.

In a Hadith, the Prophet ﷺsaid: “It is better to leave your heirs rich rather than poor, begging of others”. Even though this Hadith has specifically mentioned about the companion that would like to bequeath all his wealth for the sake of Allah, but the Prophet allowed him to give only one-third of his wealth, it implies that it is necessary for
the Muslim to seek and manage their wealth effectively. Everything spent in accordance with the Shari'ah (Islamic rules) will be counted and rewarded in this world and the Hereafter. Another objective in wealth planning is to obtain al-falah, which means to be successful in the world and hereafter which are conceptually derived from “good life” (hayat tayyiban) and paradise (jannah) (Financial Planning Association of Malaysia). In Islam, the good in life one has is different and is not subjected to only wealth, women and wine. It is accomplished by striking a balance between the material and spiritual desires of humankind. The Muslim needs to engage in wealth management to achieve his/her goal of life. In the following verses, Allah says;

“O you who have believed, shall I guide you to a transaction that will save you from a painful punishment? [It is that] you believe in Allah and His Messenger and strive in the cause of Allah with your wealth and your lives. That is best for you, if you should know. He will forgive for you your sins and admit you to gardens beneath which rivers flow and pleasant dwellings in gardens of perpetual residence. That is the great attainment.” (al-Saff, 61:10-12)

Allah promised incredible rewards for those who strive with their wealth and lives for Allah. A proper wealth management with the guidance of the Shari’ah is a means that will lead a Muslim to obtain al-falah. Wealth is a trial from Allah towards His servants. As a Muslim, we need to understand the basis of things in wealth for instance, how to accumulate, to safeguard, to purify and to distribute wealth in line with Shari’ah rules. There are five elements of Islamic financial planning, which are risk management and Takaful, Islamic investment, zakat and tax, retirement, and Islamic Estate and waqf.

IV. Concepts Of Retirement Planning From The Shari’ah Perspective

Retirement planning is a part of financial planning. The important function of retirement planning is to manage individual personal finance during periods of employment to sustain after employment years. The idea of retirement planning was conceived due to the assumptions that a person would not like to change his lifestyle after retirement. Retirement come into place when people reach a certain age, leaving their job. In Malaysia, for the government servant, the retirement age is 60 and for the private sector the retirement is from 56 to 60 years. The Department of Statistics Malaysia (2015), reported that males who reach 65 years of age in 2015 are expected to live for another 14.9 years before their death. Similarly, females were expected to live for another 16.9 years. It is important for the working individual to plan for their retirement, so that they will have sufficient fund after retirement period. The ideal retirement plan for each person will be different as people need to visualize their own retirement based on their lifestyle and requirements and goals after retirement. Several criteria represent the concept of retirement planning from Shari’ah perspectives for instance, lesson from the Qur’an, hadith, Shari’ah compliant retirement portfolio and handling the surplus.

A. Retirement planning lessons from the Qur’an

From the Qur’anic perspective, planning was generally discussed in various verses. The Qur’an teaches that wealth and planning are interrelated. Man is seen as a trustee to the wealth that was given to him by Allah so that he uses it wisely for his benefits and the
benefits of others. Islam encourages modesty in spending. From the Shari’ah perspective, a Muslim is required to set goals, priorities and costs in terms of spending.

[Yusuf] said, “You will plant for seven years consecutively; and what you harvest leave in its spikes, except a little from which you will eat. Then will come after that seven difficult [years] which will consume what you advanced [i.e., saved] for them, except a little from which you will store. Then will come after that a year in which the people will be given rain and in which they will press [olives and grapes].”(Yusuf, 12:47-49).

Prophet Yusuf interpreted the King of Egypt’s dream and the interpretation demonstrates the strategy to save and to sustain for the seven years. Besides, they have to get ready for another seven years of drought. This term is known as riding the economic cycle (Bahari, 2014). In another verse, the Qur’an states that all wealth belongs to Allah;

“To Allah belongs whatever is in the heavens and whatever is on the earth. And to Allah will [all] matters be returned” (Ali-Imran, 3:109)

The above verse highlights that all sources and wealth is from Allah. Muslims must utilized the sources wisely. Allah likes moderation in spending, therefore, Islam encourages Muslims to be in the middle of two extremes regarding spending i.e. between extravagance and miserliness. As highlighted in the Qur’an;

“And [they are] those who, when they spend, do so not excessively or sparingly but are ever, between that, [justly] moderate;” (al-Furqan, 25:67)

Besides, Allah reminds the humankind to be kind to their relatives. As Allah promised, He will reward whoever does good to his relatives and kinship and bless their wealth in their life. In Surah al-Mulk, Allah instructed us to trust and only rely on Him, yet, humankind is also being asked to work hard and try their best to obtain their goals. Indeed, relying on Allah does not mean that the man should not strive in this world. Allah says in Surah al-Mulk;

“It is He who made the earth tame for you, so walk among its slopes and eat of His provision and to Him is the resurrection”(al-Mulk67:15)

The believer should plan for his retirement not only for himself, but also to support his family. The purpose of planning for retirement for Muslim should be twofolds: to prevent against hardship and to obtain al-falah.

B. Retirement planning lessons from the Hadith

The concept of retirement, according to the Shari’ah could be considered as optional. For a Muslim, work is envisioned as ibadah and therefore, it is possible for them to work to make sure they are occupied until they pass away or they could possibly set their retirement age so that their money will work for them in their retirement years. The importance of planning can be interpreted from the hadith of the Prophet

“Take advantage of five before five: your youth before your old age, your health before your illness, your riches before your poverty, your leisure
before your work, and your life before your death” (reported by Muslim and al-Tirmidhi from ‘Amru ibn Maymun).

The above hadith emphasizes that people should take the advantages of what they have now before they lose it. This hadith can be interpreted in the context of retirement planning on the importance of people to plan for their retirement. People need to plan and save in their working days before it is too late. Retirement planning is also a process that individuals have to undergo. As a Muslim, man should not only focus his retirement planning for himself, yet, he must consider his spouse and children. Another hadith that shows the importance of leaving wealth for the family was narrated by Sa’ad:

“The Prophet (ﷺ) came to visit me during my ailment which had been aggravated during Hajjat-al-Wada’. I said to him, "You see how sick I am. I have much property but have no heir except my only daughter May I give two thirds of my property in charity?! He said, "No." I said, "Half of it?" He said, "No." I said "One third?" He said, "One third is too much, for to leave your heirs rich is better than to leave them poor, begging of others. Nothing you spend seeking Allah's pleasure but you shall get a reward for it, even for what you put in the mouth of your wife.”(Reported by al-Bukhari)

Whenever a Muslim wants to spend his wealth, he should consider and put his family as a priority. Spending wealth on his family was counted as charity. As narrated by Abu Hurairah;

“The Messenger of Allah, peace and blessings be upon him, said, “The best charity is what you give when you are independent, and you should start with spending on your dependents.”(Reported by al-Bukhari)

Humankind is countable for every single deed. As a vicegerent of Allah S.W.T, humankind will be asked about how they used their lives, youth, wealth and knowledge. Therefore, a Muslim should make his primary goals as to be successful in the world and the hereafter. A hadith narrated by IbnMas’ud says;

“Ibn Mas’ud reported: The Prophet, peace and blessings be upon him, said, "The son of Adam will not be dismissed from his Lord on the Day of Resurrection until he is questioned about five issues: his life and how he lived it, his youth and how he used it, his wealth and how he earned and he spent it, and how he acted according to his knowledge.”

Besides, the Prophet (ﷺ) also had a proper planning through as could be seen in his actions.

“Prophet (pbuh) himself used to purchase dates from BaniNadhir and saved for his family a full year’s provisions”

All the above hadiths are reliable to prove that the Muslim is required to manage his wealth and plan for his retirement. They also need to ensure that their purpose is not only to have a better life in the world but in the hereafter as well. In addition, they also
need to ensure that the products that they choose to save for their retirement purposes are in line with Shariʿah rulings.

C. Ensuring Shariʿah compliant retirement portfolio

When a person plans to have a retirement planning, either to design a plan by himself or through a financial planner; he needs to consider that the products of saving or investment were not embodied with any prohibited (haram) elements. Bahari (2014) emphasizes that one of the most challenging parts in retirement planning is to make sure that the products are Shariʿah compliant and in accordance to the existing law of the country. It is difficult to ensure the consistency of the Shariʿah compliant portfolio for a long period because some products that comply with Shariʿah at the very beginning may later on be deemed non-compliant with the Shariʿah.

D. Handling the surplus

Another important aspect of retirement planning is to make sure that the return on investment is adequate to fill up the monthly expenses need and to meet other financial obligation fulfilled. Therefore, it would be better if someone plans for his retirement to ensure that the investment vehicle will generate income and the income generated can be withdrawn, reinvested or disposed whenever needed (Bahari, 2014).

Apart from retirement planning, it is also important for a person to pay alms giving (zakat) to purify the wealth. The zakat can be paid through either the company level or individual level. Furthermore, if there is extra from their retirement saving or investment after they fulfil their needs, the surplus can be transferred in other way such as waqf, sadaqah etc. Mankind will be rewarded for every single cent he spends for charity and it is continuous reward received by them for their good actions and deeds. The charity that they perform will not only benefit them in the world, but will continue to benefit them even after death. There is a hadith narrated by Abu Huraira;

“Prophet ﷺ said: When a son of Adam dies, all his good deeds comes to an end except for three; recurring charity, knowledge that benefit others and the supplication of a pious son, who prays for him (for the deceased)” Reported by Sahih Muslim.

Wealth that has been spent in the way of Allah S.W.T is considered as future investment that will offer everlasting sustenance. Allah S.W.T says in the Qur’an:

“And spend [in the way of Allah] from what We have provided you before death approaches one of you and he says, "My Lord, if only You would delay me for a brief term so I would give charity and be among the righteous."Surah al-Munafiqun, 65:10.

Spending the surplus is also considered as an investment. As the aim of a Muslim is not just to get the blessing in the world but hereafter as well. So, spending in the way of Allah S.W.T is another investment that will benefit mankind which Allah will multiply the rewards many times and return him with a noble reward.
V. Realizing Maqasid al-Shari’ah in Retirement Planning

The objective of a Muslim must be in line with Maqasid al-Shari’ah, that is the objective of Shari’ah. The comprehensive meaning of Maqasid al-Shari’ah contains the holistic worldview of Islam in promoting justice, brotherhood and social welfare (Dusuki & Abozaid, 2007) in this world and hereafter (Kasim, 2015). For the same reason, the objective of Shari’ah is to promote the benefits (maslahah) and to protect mankind from harms (mafsadah). Through the objective of the Shari’ah, mankind will be able to obtain al-falah and hayatan toyibah (Sulaiman, 2011). Also, in order to allow Muslims to keep pace due to changes in civilization and human needs, considering maslahah as a tool could facilitate in capturing human needs in accordance to the Shari’ah rulings (Vejzagic & Smolo, 2011). Thus, Maqasid al-Shari’ah comprises all disciplines such as laws, principles, actions, policies and instructions that are specifically designed to protect all aspects of human life. Maslahah submits ease and flexibility for the Muslim to deal with current activity such as muamalat for the sake of the ummah.

According to al-Ghazali, the objective of Shari’ah consists of five elements: safeguard of religion, life, intellect, progeny and wealth (Al-Mubarak & Mohammad Osmani, 2010; Firdaus & Ismail, 2014). Al-Shatibi classifies maslahah into three levels: daruriyat (necessities), Hajjiyyat (needs) and tahsiniyyat (embellishments) (Laldin, 2010). Figure VI.2 represent the levels of maslahah according to their categories.

Accordingly, retirement planning goals include goals that are needed to bring ease in life (Al-Masalih al-Hajjiyyah). This part is also important since it supports the necessities, disregarding hajjiyyah will cause difficulty and hardship (Al-Mubarak & Mohammad Osmani, 2010; Laldin, 2010). Some retirement goals that are needed for ease
of life should also be planned for. Take for instance a vehicle or furniture in the house are all needed even after one retires. Disregarding this part may cause hardship and distress not only to a person, but to his entire family. This has been noted by the Prophet (pbuh) in the following hadith:

“The Prophet: came to visit me during my ailment which had been aggravated during Hajjat-al-Wada’. I said to him, "You see how sick I am. I have much property but have no heir except my only daughter May I give two thirds of my property in charity?"! He said, "No." I said, "Half of it?" He said, "No." I said "One third?" He said, "One third is too much, for you to leave your heirs rich is better than to leave them poor, begging others. Nothing you spend seeking Allah's pleasure but you shall get a reward for it, even for what you put in the mouth of your wife." (Reported by al-Bukhari)

From the above hadith, the Prophet ﷺ highlights the importance to place family like a wife and children as a priority in wealth distributions. Besides, the Prophet ﷺ also reminds Sa’ad to leave his wife and children wealthy rather than to leave them poor, depending on other people. The importance of protection of wealth is also highlighted in the hadith narrated by Sa’eed Ibn Zaid which reads:

I heard the Prophet ﷺ say: “Whoever is killed protecting his wealth is a martyr, and whoever is killed protecting his religion is a martyr, and whoever is killed protecting his life is a martyr, and whoever is killed protecting his family is a martyr” (Reported by at-Thirmidhi).

Al-Masalih al-Tahsiniyyah(embellishments) is the highest level on the pyramid of maslahah that represents sophistication and accomplishment(Laldin, 2010) in obtaining desirable reputation and actualization(Al-Mubarak & Mohammad Osmani, 2010). In a retirement plan, this aspect should be given the least attention. It normally arises due to the surpluses obtained from investment or at most a little proportion from the retirement plan because people are expected to have less income during this period. Although this aspect will be given less attention, a good Muslim should have some little amount from his earnings as charity in the form of sadaqa, waqf, etc. In fact, at late ages of one’s life, he should consider giving out as much as will not affect his necessities (dharuriyyat) and needs (hajiyyat) as possible.

VI. Conclusion

Retirement planning is one of the six important elements of financial planning. From the discussion above, it is clear that people should prepare for their retirement. To a certain level, the concept of financial planning for Muslim is different from its conventional counterpart. Financial planning in Islam is considered as worship (ibadah) that aims to prevent hardship and to obtain al-falah simultaneously.Muslims acknowledge that Allah S.W.T is the creator and owner of all wealth. As a vicegerent of Allah S.W.T, a Muslim is accountable for what and how he spends the wealth. Therefore, a Muslim should spend his wealth responsibly and in accordance with the Shari‘ah.

Hitherto, there is growing literature on financial planning in general, yet, still there is paucity of research conducted in retirement planning from an Islamic perspective. This paper highlights several lessons from the Qur’an and hadith on the importance of
planning in general and specifically for retirement planning. It is hoped that this study will give some insights to the government, policy makers and financial service providers to focus on the development of Shari’ah-compliant retirement products in the future. The researchers are encouraged to further investigate retirement planning by utilizing various methodologies for the sake of knowledge enhancement. Future empirical research requires studying the awareness and behavior of Malaysian employees towards retirement planning from an Islamic perspective.

References


Modaraba: A Viable Option for Project Financing

By
Muhammad Ali Shaikh*

Abstract:
Conventionally project finance (PF) is limited recourse finance (LRF) based on non recourse to the sponsors and relies mainly on the project cash flows which closely resembles Modaraba. There are many things common such as project’s viability as investment criteria, monitoring by banks, non recourse to sponsors and management control. Key issues such as risk of loss have many similar dimensions.

Modaraba option has some benefits which make it a better alternative. For example if project fails, the bank as owner can quickly liquidate the assets to improve recovery. In case of mismanagement and violation of contract, the bank can assume control and fix responsibility on the Modarib for losses. Besides losing remuneration for his work, his reputation is also at stake. Therefore delegation of managerial authority to Modarib is not a blank cheque. Capital gain in successful projects accrues to the bank where as in a loan situation it goes to the project. Collateral is a fallback position in LRF but is not needed in Modaraba.

The limited exposure of IBs in PF business needs enhancement for which a market niche exists, particularly in Pakistan where the field is open without significant competition after the closure of DFIs.

Key words: Modaraba, Project Finance, Islamic banking, Limited Recourse Financing (LRF)

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* Author: Muhammad Ali Shaikh is a retired senior banker and retired professor of engineering economics at NED University of engineering and technology, Karachi, Pakistan. Since his retirement he is teaching subjects of financial management and Islamic finance at leading business schools in Karachi.
1 Introduction

The asset portfolio of Islamic banks (IBs) mostly consists of Fixed Income (FI) assets such as Murabahah and Ijarah. Assets based on Profit and Loss sharing (PLS) have nominal existence. This trend is in sharp contrast with the theoretical model which considers PLS financing as the main method but reflects the level of risk; the Islamic banking industry is prepared to take at present.

Since the income generated by the asset portfolio is shared between the banks and depositors, it determines the return to be paid to them. The ability to transfer actual profits or losses of the asset portfolio to depositors induces stability in an Islamic bank but requires a portfolio structure with lowest risk. PLS assets involve investment risk which is more unpredictable as compared to fixed income (FI) assets involving credit risk, which is also familiar to the banking industry. Therefore besides halal income, the portfolio risk is an important element in deciding the asset structure of IBs. However as shown by the latest data released by State Bank of Pakistan (SBP) a gradual shift in the asset structure of IBs to increase share of PLS assets has started now in Pakistan (SBP, 2016).

Similarly project finance (PF) also has nominal existence in the asset portfolio of IBs. PF business, although profitable, also involves high risk and needs additional skills for risk evaluation and management. The risk consideration is genuine but some good business is foregone to conventional commercial banks.

Conventionally project finance is limited recourse finance (LRF) based on non recourse to the sponsors of the project and relies mainly on the project cash flows for the servicing of its debts. In case of project failure the bank has recourse to the project assets and most likely will have to face loss depending on the realizable value of the assets at that time. This methodology is used by conventional banks using interest based loans. Islamic banks would use FI products such as Murabahah and Ijarah which finally become debts. The key principle i.e. project profitability, non interference in the management and non recourse to the sponsors / managers closely resemble the features of Modaraba which if adapted will not change the nature of risk. Additional positive features as discussed in this paper make it a more attractive alternative for PF.

The common perception that Modaraba based project financing would require Islamic banks (Rubul mal) to delegate managerial decision-making to the entrepreneur (Modarib) is a blank cheque is not correct. Modarib is required to work diligently within usual business norms, exercise due care, work with full integrity and honesty, follow restrictions or conditions such as the type of business, authority to raise or give debts etc. imposed at the time of contract and be responsible for loss if caused due to his carelessness or overstepping the authority. The bank as owner can also take over project in case of mismanagement or violations of the terms. Therefore the IB’s risk exposure would be limited to genuine business loss excluding the manager’s negligence or fraud which is one of the main concerns preventing adaption of Modaraba.

2 Literature review

Historical evidence suggests that Modaraba has been in use since early Islamic society (Kahf and Khan, 1992) and even before and was adapted after the advent of Islam (Tanzillu Rahman, 1999). Trade being main activity, this method was used to finance
trade. According to Ghouse (1980), international trade, aided by command over ocean transport, has been the hallmark of traditional Arab society which was continued even after the advent of Islam, extending to Europe and other parts of the world using partnership contracts as the main source of financing. The sea route connecting the Mediterranean with red sea provided a link for speedy transport of grain from Egypt to Hejaz. Trade links were established with China, Sindh, Spain and Far East countries for commodities like textiles, carpets, ship building, drugs and armaments etc. showing the extent of trade between Muslims and the rest of the world.

The trade caravans were special projects financed through special purpose Modaraba. In these small localities where everyone knew each other, finding financiers or managers with dependable integrity and capability was not a problem making it possible on personal basis without the requirement of specialized institutions of today. The market environment in the present times calls for the role of intermediation between the investors and entrepreneurs to be performed by the present day Islamic banks. Since their own profits depend on the success of these projects and in turn the entrepreneurs they select, the banks must perform this function in the best possible manner. As sole owner of the assets in the financed projects the banks will have full legal authority to effectively monitor projects and to recover investment in case of management failures. The bank being owner of the assets, there is no need for collateral and therefore no projects will be refused due to non availability of collateral (Abdul Ghafoor, 2006)\(^1\).

Kahf, Ausaf and Hamoud (1998) argued that in lending, the lender gives real goods (be it life-time savings or any other loan able goods) to the borrower against a notional right, called debt changing the nature of what is owned from real balances to a legal commitment. In contrast financing on the basis of sharing is based on justice. The financier retains ownership and both parties participate in creating value which is shared equitably without throwing the risk burden on one side while relieving the other completely. Losses are also carried in proportion to financing advanced according to the rule of “gains should always be linked to risk exposure”. Thus finance on the basis of PLS opens the way to direct investment, where utmost attention of the bank is directed to profitability of investment.

According to Kahf and Khan (1992) ownership in assets have two inherent characteristics: Right to all earnings, increments and risk and responsibilities relating to these assets. The assets could be managed by owner himself (e.g. trading) or assigning the management of usufruct (e.g. renting) or contractually giving up management to someone else (e.g. Modaraba).

Modaraba contracts when used on the asset side involve issues for the banks such as risk of loss; moral hazard (Ahmed, 2002) and management control which needs a long term and enterprenural approach\(^2\) by the bank (Dar & Presley, nd). Aljarbi (nd) argues that the risk of loss to asset portfolio can be mitigated through better selection of projects and management.

\(^1\) See also Tanzillu Rahman (1999).
\(^2\) This suggests the suitability of Modaraba for project financing which also needs long term and entrepreneurial approach.
The structure of deposits which is usually short term as supported by SBP data (SBP, 2016) may be a reason for lack of PF by Islamic banks in Pakistan. According to a study by Iqbal and Khan (1998) lack of project financing in most Muslim countries may be diverting investment into real estate or trading.

Obedullah (2005) terms PF in line with the mission of Islamic banking. Investments in large infrastructure projects in developing Muslim economies will accelerate economic development and create value and wealth as opposed to investment in Islamic equity funds, which generally involve an outflow of capital from these resource-starved economies into the developed ones. He has further discussed how various contracts that lead to risk allocation among the parties could be amended in an Islamically acceptable manner that is free from Riba and Gharar.

Babai, (1998) terms PF and Islamic finance as tailor made for each other and regards PF as top priority for IBs. He argues that with the adaption of LRF, the financiers now look at the performance and cash flows of the project instead of sponsors’ the assets. Relating economic growth with infrastructure he maintains that large infrastructure projects in many Muslim countries offer a lot of scope for new PF business. This corresponds with the mission of Islamic banking to create value. He terms benign economic environment, liquidity management, higher transaction costs and lack of capability such as the required skills set as the main constraints responsible for low investment in PF business by Islamic banks.

Siddiqui (1999) has discussed various options available for financing infrastructure projects requiring huge capital. According to him a variety of instruments using PLS modes or Murabaha could be structured to finance these projects.

Pakistan, in June 1980, introduced Modaraba funds, to provide a Shari‘ah compliant alternative. The law introduced an enabling institutional structure comprising of a Modaraba Management Company (MMC), Modaraba fund to be floated as a separate legal entity and managed by MMC, the regulator i.e. Securities and Exchange Commission of Pakistan (SECP) through its Registrar of Modarbas and religious board. To protect public interest MMC is required to subscribe a minimum of 10% of the fund making the structure a combination of Modaraba and Musharaka. The investors do not have voting rights to fulfill requirements of Modaraba. In contrast a mutual fund is regulated through different rules and share holders have voting rights. Another significant difference is the management fee as a percentage of net asset value in case of mutual funds as against a share in actual profits in case of Modaraba funds. Issuance of prudential regulations in 2004, shariah compliance and audit mechanism in 2012 by the regulators and code of conduct by Modaraba Association (MAP, 2013) has further improved the system.

Although leasing is the main financing instrument (MAP, 2015) there have been some efforts to diversify into project financing or similar activities. Faizan Manufacturing Modaraba (MAP, 2006) was established for a period of 5 ½ years by the MMC jointly owned by three banks to construct, own, operate and manage a polyester staple fiber (PSF) plant which manufactured PSF for ICI under an agreement. At maturity the Modaraba was liquidated. The plant was sold to ICI at fair market value yielding capital
gains improving the annual payout from 9.5%--14.3% to 29.4% in the final year. Treet Manufacturing Modaraba owns a plant manufacturing packing material. The Modaraba went into backward integration and acquired a paper and board mill to improve its operations. There are few Modarabas with trading as the main activity which indicates shift towards real risk taking business.

3. Methodology

The similarities between the principles of LRF and Modaraba suggest that its overall suitability for PF should be investigated. Accordingly this study builds on the analysis of the features of LRF and Modaraba as PF instruments and a study of the similarities and differences to find an answer. The LRF when referred in this study includes financing by conventional banks using interest based loans and Islamic banks using FI instruments such Murabaha or Ijarah which finally become debts. The following hypothesis was developed and tested.

H1: Modaraba is similar to LRF and a suitable alternative for PF.

4. Analyses

4.1 Project financing methodology.

The LRF methodology focuses on project viability and cash flows as basis for the financing decision with no recourse to the sponsors. The project's assets and rights or interests conferred by various contracts are taken as secondary security which is a fallback position, should the project cash flows go below the expected or projected levels. Being off balance sheet financing sponsors avoid taking risks on their own balance sheets. Generally a separate project company is established to own and operate the project thus shielding it from other assets of the sponsors to which the lenders will have no recourse thus making risk identification and allocation a key consideration for them.

The project managers (appointed by sponsors) have complete freedom for management decisions without interference of the financiers and would also take no responsibility for project failure. They would however receive management remuneration even in case of loss.

Modaraba financing product prepared by SBP (2005) was taken as a model for the purposes of this study which is described below:

i) Project financing proposal will contain complete information including: description and cost of the project, profit and cash flow projections, client information and management services he offers.

(ii) The client covenants that he will provide management services to the best of his ability, will use the assets of the project exclusively for the purposes of the project, will maintain all assets free from all encumbrances, will submit periodic information such as cash flow, balance sheet and income statement with an explanation of variations from the projections, will maintain true books of accounts and give access to the bank as and when required, will not do any transaction where he or his family members have interest and conduct the project’s business in accordance with law and requirements of Shariah.
(iii) Disbursement and collection of funds will be through a special account maintained at the bank that shall have the right to block payments not related to the project.  

iv) Actual profits worked out on the termination date on the basis of accounts drawn up in accordance with accepted accounting principles, shall be shared in the specified ratio. Interim profit can be paid periodically subject to adjustment in final accounts. The bank can give incentives to the manager for better performance. Loss would be taken by the bank which may reduce its capital but in the event of the project moving towards a loss situation the manager shall give notice of such a situation to the bank supported by all relevant information. While the bank gets timely notice to safeguard its interest, any loss caused due to manager’s negligence will be made good by him.

v) The Modaraba will terminate on the date specified. The client will plan and conduct the business in a manner that the assets are converted into cash by the termination date. While the investment will be returned promptly, the final profits can be paid after finalization of the accounts within a specified period.

vi) Subject to above conditions the management would vest in the client who will be responsible for management and control of the project. However in case of violation of the conditions and covenants by the client, the bank after notice can terminate his powers to manage the project and assume control itself. The client will be entitled to his due share in the profits up till the date of takeover by the bank.

The above structure envisages that the bank’s investment decision will be based on detailed appraisal covering profitability, cash flows, management capability and entrepreneur’s express warranty regarding correctness of the information and data provided by him. Modaraba will be liquidated at maturity to retire principal investment. The assets can either be sold in the market or to the client.

In summary the overall methodology in both cases is similar notwithstanding few differences. Project performance would determine the profits and recovery of bank’s investment and is the basis for financing decision along with full authority to manager for managing the project without recourse to him except that in case of Modaraba the recourse is available if he performs imprudently or violates the agreed terms or well established rules and procedures.

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3 This is similar to escrow arrangement in limited recourse project financing which is a universally acceptable method and can also assist the Islamic bank in its monitoring function.

4 who can continue with the project as happened in case of Al Faizan manufacturing Modaraba (MAP, 2006)
4.2 Comparative study of Modaraba and LRF and handling of main issues

A comparative study of Modaraba product structure and LRF indicates many important similarities between Modaraba and LRF which is already being used by banks, thus increasing the scope for acceptability and adaption of Modaraba. The main issues such as: criteria for investment or financing, return on bank’s investment, risk of loss and management control etc. have many common dimensions. While a summary is presented in table 1, detailed analysis is presented in the following sections.

4.2.1 Project Selection and Criteria for investment

In both cases detailed appraisal is conducted to establish financial and economic viability of the project, capability and integrity of the management including risk evaluation before taking a financing decision. The client who is responsible for management in either case develops an action plan to satisfy the bank regarding proposed mitigating measures for each risk in the business plan. Principally both methods are cash flow based. However profitability is also given due weightage in case of Modaraba as the return on capital of the bank is based on profits.

In the conventional method discount rate (DR) in DCF analysis is based on the average cost of capital which is influenced by the market interest rates. The interest rate criteria, as also argued by El-Ghazali, (1994), may compromise on the economic efficiency because the market interest rates are determined by factors other than the profitability of projects and may lead to incorrect project selection resulting into incorrect resource allocation. Since profitability is also given due weight in case of Modaraba, the DR will be selected on the basis of bank’s desired rate of return reflecting the opportunity cost of such funds or the bank’s desired rate of return. This option is more close to the profitability criteria and will help select viable projects on merits resulting into more efficient resource allocation. This will also avoid reference with interest rates.

4.2.2 Dealing with Unexpected performance

Project appraisal and related risk assessment is on the basis of projections and expected performance in future which may show unexpected departure as compared to the estimates due to changes in operating environment or management inefficiency or both. To deal with it tools such as selection of trustworthy and capable managers in the first place and then monitoring their performance etc are available to the banks and can be used equally under both methods i.e. LRF as well as Modaraba based financing.

4.2.3 Monitoring

The management will provide regular information about operations of the project to enable the bank to assess performance and to see if there are potential troubles. Escrow arrangement further assists in the monitoring function. However the Modaraba structure

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5 Bank can evaluate actual performance in comparison with the projections and ask the management to explain in case of lower performance thus bringing pressure on the management to perform.
allows the banks (Rabulmal) full access to information and the books making it easier to conduct in depth analysis of the performance and to decide whether the deviations (if any) are genuine calling for corrective measures. If the deviations are due to negligence or are intentional or the earlier projections were overstated to get financing, it will constitute a violation of the agreement in the former case and misrepresentation in the later. The bank can ask for corrective actions and in case of failure can terminate Modaraba and assume control and claim losses. Such options are not available in case of LRF although monitoring is used as a major tool which can only create pressure on the project management to improve performance. Even the access to information is limited to the disclosure by the managers in terms of the financing agreements as compared to complete access in case of Modaraba.

Deficiency in the monitoring capability (if any) can be built. The models in use by conventional banks or development financial institutions (DFIs) in some countries such as Pakistan are well recognized and can be adapted with necessary improvements based on review by Shariah advisors.

4.2.4 Return on bank’s investment.

In a conventional set up return on the borrowed capital is known and paid in the form of interest at pre agreed rate(s) and principal is amortized at face value periodically out of the actual cash generated by the project. A default in one period can be corrected in the following period but if losses and/or cash flow shortages persist there can be a permanent default. Similar problems will occur in case of financing by IBs through FI instrument such as Murabaha where the differed sale price is like a debt except that the bank’s rate of return will suffer a decline if payment is delayed because sale price cannot be increased and charity payment increases cost of the borrower but does not compensate the bank.

In case of Modaraba return is based on actual profit which is not known until final accounts are prepared at end but can be estimated and periodically paid based on profitability projections subject to adjustment in the final accounts. Impact of cash flow shortages will be less because only interim profit is to be paid during the life of Modaraba. The principal is paid at maturity out of the sale proceeds of assets. The assets could be sold to third parties or to sponsors / managers as discussed earlier who will always be willing to pay a price to avoid a capital loss in case the market value is depressed in order to establish their credibility in the market.

4.2.5 Risk of loss to the bank

As discussed in preceding section losses and cash flow shortages will lead to default irrespective of the method of financing. This will happen due to unexpected poor performance which is partly managed through careful appraisal and partly through

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6 Cash flow shortage can even happen in case of profits. For example the gross cash generated by the project will require adjustments for changes in net working capital. If conditions such as circular debt in power sector in Pakistan persist there can be an abnormal increase in the net working capital thus reducing the net operating cash flow affecting debt servicing. Cash flow problems could also emerge due to financial mismanagement.
selecting trustworthy and capable managers and monitoring their performance. However, the other side of the picture which makes the issue critical in PF is the fact that projections cannot be made with reasonable accuracy over a long period particularly in economies with unstable economic and political environment. Therefore risk of loss to the project and consequently to the bank would remain a common issue under both options.

In case of LRF the bank faces credit risk and is not bound to share business loss but as explained earlier cash flow problems\(^7\) can lead to a permanent default position and there being no recourse available to the sponsors the recovery will be limited to collateral and assignment of rights as explained later. Similarly in case of Modaraba the recovery will depend on the market value of assets. Therefore it can be concluded that the choice of financing vehicle does not significantly affect the risk of loss to the bank and is inherent to the business of project financing. But since the manager also faces risk of losing reward for his work and more importantly his reputation, he would always put his utmost efforts to bring good results.

Modaraba offers even more. In the event of project moving towards a loss situation the manager shall give notice of such a situation to the bank supported by all relevant information providing opportunity to safeguards its interest.

If project fails the bank as owner can ask the manager to sell the assets without wasting time to avoid depreciation in market value thus improving recovery. If it is a management failure, the bank can assume control of the project and manage the project itself or hire new management. The bank can also fix responsibility on the Modarib for losses due to imprudent management and negligence although we have no history to substantiate the practical feasibility of such a safeguard.

### 4.2.6 Ownership and Capital gain

Ownership of assets lies with the project in case of LRF and with the bank in case of Modaraba entitling the bank for a capital gain if the asset value increases whereas in the former case capital gain will accrue to the project. Capital loss will be absorbed by the bank directly in case of Modaraba and indirectly through default in case of LRF. Thus in a loan situation gains are kept by the enterprise transferring losses to the bank through default but in case of Modaraba the bank has equal opportunity to get gains, not only the losses.

### 4.2.7 Recourse to sponsors.

Recourse to the sponsors is not available to the bank in case of LRF when default or failure occurs but is partly available in case of Modaraba when loss or failure is due to carelessness or dishonest dealings by Modarib.

### 4.2.8 Collateral

Although a fallback position, collateral is obtained in LRF in the form of mortgage on the assets of the project, assignment of rights and project cash flows. The market value

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\(^7\) Financial mismanagement can also lead to cash flow problems even when there are no losses.
of project assets would be depressed due to forced sale\(^8\) and will further depreciate with lengthy legal process falling short of the loan liability\(^9\).

In Modaraba financing, bank being owner, mortgage or assignment of rights or the cash flows is not needed. The assets can be sold on termination date without observing recovery procedures as the bank is the owner of assets. Therefore situation like a forced sale will not be created and realized value will be equal to the market value.

### 4.2.9 Management control

In case of LRF the projects are owned by a special purpose Project Company and managed through professional managers who usually have no financial stake in the projects. While the sponsors usually have some financial stake, majority stake comes from banks having no recourse to the sponsors or the managers. Therefore they are the real stake holders who bear maximum risk and depend solely on the performance of the project for the safety of their loans. Although effective control is not possible, nominal control can be exercised by lenders using their rights to nominate a director or use covenants putting restrictions on the appointment and removal of key officers and dividend announcements in addition to getting an option for a debt/equity swap in case of default.\(^10\) Similar measures can be taken by Islamic banks using FI financing techniques like Murabaha which finally becomes debt.

Except these indirect measures, management control is not possible in case of LRF and Modaraba is not an exception. But in case of Modaraba the financier can cancel the management contract and assume control under specified conditions as discussed above. It is only under these specified conditions when management control becomes important.

Lack of management control has not prevented the conventional banks to undertake PF business and similar should be the behavior of IBs in case of Modaraba. The fact that Modaraba signifies a PLS risk as compared to a credit risk in case of LRF\(^11\) has no practical significance because this difference does not materially influence the final outcome as discussed earlier.

This problem has yet another dimension. Should the banks really have some role in or control over management to safe guard their interest? Do the banks know and have required capacity to exercise management control if provided an opportunity. The answer is not simple because it involves capacity building in the banks such as manpower,

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8. The projects will most probably be closed before initiating legal actions requiring time consuming procedures and are not likely to yield full value to cover the liabilities towards banks increases with time due to application of interest in addition to other liabilities ranking senior to the bank debts for example the salaries, forcing the bank into a write off.

9. In case of FI Islamic instruments the amount remains frozen which decreases bank’s rate of return although charity payment will increase project’s total liability.

10. D/E swap is an effective method of controlling intentional default according to author’s experience

11. As discussed in this paper repayment of bank finance depends on the cash flow therefore choice of financing vehicle will have no significant effect on the risk.
procedures and experience. In the absence of proper capacity it may bring more responsibility than the benefits. Even the indirect controls such as a seat on the boards may result in more responsibility than the benefits.

Therefore it may be concluded that lack of management control is not unique to Modaraba. Management is the right of managers which cannot be diluted. However authority and responsibility must go together. This is the point where Modaraba offers better solution by making Modarib a trustee / ameen to manage the business faithfully and honestly and to take personal responsibility for loss caused due to his negligence or irresponsible behavior as compared to other methods where the theory of limited recourse offers them immunity like the limited liability concept in case of LLCs. The best option is to develop capability in banks to oversee the right use of authority by the managers and prevent its misuse.

However, should there be a need to intervene and take over the project; it would be easily possible in case of Modaraba as discussed earlier. Thus, practical limitations apart, the Modaraba based financing provides additional tools to deal with the issue of management control as compared to LRF.

4.2.10 True preparation of accounts

True preparation of accounts however remains the concern. Selection of trustworthy sponsors and auditors and training of bank staff in monitoring can address this issue adequately. Once the managers know that they can be made accountable, the possibility of playing with the accounts will almost be eliminated. This issue is equally important in case of LRF to prevent default.

4.2.11 Liquidity

Long term loan is amortized periodically but the original investment in Modaraba will be returned at maturity. As such liquidity is an issue in case of Modaraba financing particularly when the deposits of IBs are mostly short term. Securitization of Modaraba assets, the Modaraba management company (MMC) structure as discussed later, and matching long term deposits for specific projects can solve this problem.

However, the IBs presently being highly liquid may not find it difficult to have some portion of the portfolio allocated to PF based on Modaraba provided they are otherwise prepared to undertake PF business.

4.4 Structure under Modaraba law in Pakistan

The structure under Modaraba law in Pakistan can be adapted to finance specific projects or a group of projects / assets. Islamic banks can establish a MMC and float a fund to own and operate a project. The banks through MMC will assume the role of Modarib (manager) while subscribers to the fund will take the role of investors (rabul mal) providing entire management control to the banks. The project can either be managed directly by the MMC (i.e. banks) or through an operator.

Since law allows MMC’s participation in the fund, banks can invest their own money through MMC. The fund could also be leveraged as per leveraging criteria for non
bank financial companies (NBFC’s) to enhance resources for undertaking more projects or large size projects. The underlying assets being projects, the instruments used to leverage the fund can be appropriately securitized to allow liquidity to the subscribers.

5. Findings

The above analysis shows that the methodology in Modaraba based project financing would be similar to LRF although there are some differences necessary to maintain the Shariah compliance requirements of Modaraba instrument but are not material to change the LRF methodology.

Key issues such as management, risk of loss and recovery of bank’s investment have many similar dimensions. The processing and risk mitigation measures such as appraisal of projects, business risk analysis and subsequent monitoring etc. are largely similar and therefore well known to the banks. In both cases the management vests with the sponsors and the bank has the right to monitor project performance and take permissible corrective actions to protect its interests.

The study also points out some inherent strengths of Modaraba as compared to LRF such as ownership of assets, takeover in case of project mismanagement, simple and quick liquidation procedures which prevent unnecessary depreciation of the value of assets suggesting that it offers a better structure as compared LRF.

This leads to conclude that Modaraba can be adapted as a suitable rather better alternative for Project Financing as compared to LRF using interest based loans or FI Islamic instruments such as Murabaha etc. which finally result into debt. Therefore hypothesis H1 is valid.

6. Discussion and scope for further research

Project financing promotes development which is one of the objectives of IBs. Although there are few success stories the exposure of IBs in PF is limited which if increased will help achieve development objective besides diversifying business.

Adaption of Modaraba as PF instrument will also increase share of PLS instruments in the asset portfolio of IBs thus reducing criticism regarding similarities in the asset structure with conventional banks. Being in the evolution stage and thrilled by past growth rates the tendency to maintain these rates is natural and explains the reluctance of Islamic banks to enhance PF business based on Modaraba. However a gradual increase will not create a big problem of portfolio risk. Constraints such as human resources and skills set will be removed in due course.

Portfolio risk has two dimensions: Risk associated with the Modaraba instrument in comparison to loans or FI Islamic instruments and the risk of loss associated with PF itself. It has already been shown in this paper that adaption of Modaraba will not adversely affect risk of loss. The second dimension is more important. PF being long term involves different types of risks that need to be managed such as liquidity, mismatch in the maturity of assets and liabilities of IBs and project monitoring. The disruption in policies due to economic and political instabilities in the countries hosting IBs which not only affect future viability of projects but also limits the capability to prepare projections.
for a fairly long period. These are important issues but as discussed in this paper, methods are available to resolve these issues.

Liquidity issue should not be treated only as a problem. It also provides an opportunity to develop alternative methods rather than as a limitation to hold back. Development of matching long term deposits to suit the needs of customers with long term risk appetite and other structures such as the MMC option can be used.

It also provides an opportunity to develop Islamic securitization, related products and supporting secondary markets where these instruments could be traded. Never the less the availability of such methods with the conventional banks has not helped much. Rather sale of debt to transfer the risk of bad assets through sophisticated financial products became a practice putting the whole system at risk. Since Islamic securitization involves real assets and corresponding revenue generated, such risks can be avoided.

Last but not least; it is the approach of the stake holders. Being familiar with the short term collateralized financing and other short term methods to generate profits; lack of interest in long term investment is likely to persist. However business diversification is a necessity which cannot be avoided for long.

7. Conclusion

Project financing based on Modaraba is similar to LRF rather a better alternative. IBs preparedness to enhance project financing business is required for which a market niche exists, particularly in countries like Pakistan where the field is open without significant existence of competitors after the closure of Development Financial Institutions (DFIs).

8. References


Capital Structure Decisions in Islamic Banking: Empirical Evidence from Pakistan

By
M. A. Rehman Shah1∗, A. Rashid**, M. Khaleequzzaman***

Abstract
This study aims to explore the determinants of capital structure in the Islamic banking industry of Pakistan. It also aims at exploring the effects of macroeconomic conditions and policy variables on the financing decisions of Islamic banking industry. To do this, the study uses an unbalanced panel data covering the period from 2006 to 2012. The results from fixed effect model indicate that bank-specific variables, namely bank size, tangibility, and growth are positively related to banks’ capital structure, whereas profitability, liquidity, and capital adequacy ratio are negatively related to the capital structural decisions of banks. On the other hand, real interest rate and inflation are negatively related to the capital structure of Islamic banking industry, while industrial production index has a positive impact upon the capital structure decisions of the Islamic banking industry of Pakistan.

Keywords-Capital Structure, Islamic Banking Industry, leverage of Islamic Banks

1. Introduction
How do Islamic banks decide their capital structure? How should they finance their operations? What bank-specific factors influence these decisions? Do macroeconomic factors affect capital structure decisions of Islamic banks? These are important questions which should be addressed explicitly. Indeed, several studies like Misman (2011), Gropp and Heider (2010), Ali (2011), Amidu (2007), Vitor and Badu (2012), Houston, James,

* Authors: 1Basic Sciences and Humanities Department, University of Engineering and Technology Taxila, Pakistan, a.rehman@uettaxila.edu.pk
** International Institute of Islamic Economics, International Islamic University Islamabad, Pakistan, abdulrashid@iuiu.edu.pk
*** School of Islamic Banking & Finance, IIIE, International Islamic University Islamabad, Pakistan, mkhaleequzzaman@yahoo.co
and Marcus (1997), Jayaratne and Morgan (1999), Akhavein, Humphrey, and Berger (1997), Ali, Akhtar, and Sadaqat (2011), Koziol and Lawrenz (2009), and Gul, Khan, Razzaq, and Saif (2012) have explored the empirical determinants of the capital structure decisions of conventional banks. Further, some studies, such as Bellinetti (2009), Wilson and Wolfson (1990), Graham, Lemmon, and Schallheim (1998), Antoniou, Guney, and Paudyal (2008), and Alper and Anbar (2011), have also examined the impact of macroeconomic factors, such as GDP, inflation, interest rates, and taxes, on conventional banks’ capital structure decisions. However, the focus of these studies was on conventional banks rather than Islamic banks. Overall, these studies have documented that the bank-specific variables, namely bank size and the tangibility of banks, are positively related to the capital structure decisions of banks, whereas, the profitability and liquidity of banks are negatively correlated with banks’ capital structure. These studies, in general, have also shown that macroeconomic variables, such as GDP, inflation, and interest rates, are significant in explaining conventional banks’ capital structure decisions.

However, when we look at the literature on Islamic banking we find only a handful studies like Rajhi and Hassairi (2012), Ahmed (2007), Al-Deehani, Karim, and Murinde (1999), and Nagano (2009) that discussed the capital structure of Islamic banks. The latter two have examined empirically the determinants of Islamic banks’ capital structure, while the former two have discussed theoretically the issues related to the capital structure of Islamic banks/firms. Thus, our understanding of how, what, and to which extent bank-specific and macroeconomic variables affect the capital structure decisions of Islamic banks is relatively limited. Yet, in principle, the capital structure of Islamic banks significantly differs, in terms of resources of funds as well as uses of funds, from the capital structure of conventional banks. Therefore, it is worth exploring to know the factors that are significant in determining the capital structure decisions of Islamic banks.

According to the trade-off theory of capital structure, a company balances tax savings from debt financing against the cost of borrowing such as bankruptcy costs and financial distress. However, according to the pecking order theory of capital structure, due to the presence of asymmetric information and adverse selection problems, a company first opts to use internally generated funds then debt financing and only in extreme circumstances issues new equity to finance its investment and other capital needs.

Besides theoretical developments in the area of capital structure, a significant progress has been made empirically in understanding the determinants of financing decisions resulting in voluminous empirical studies, which tested various capital structure theories. For instance, see Bradley, Jarrell, and Kim (1984), Smith and Watts (1992), Strebulaev (2007), and Turner (2010) on the application of trade-off theory in capital structure; Myers and Majluf (1984), Opler and Titman (1995) and Shyam-Sunder and Myers (1999) on the application of pecking order theory and capital structure; Baum, Caglayan and Rashid (2013) on the impact of macroeconomic variables and business risks upon capital structure decisions; Baker and Wurgler (2002) and Welch (2004) on the market forces and capital structure; Scholes, Wilson, and Wolfson (1990) and Graham, Lemmon, and Schallheim(1998) on the tax advantage of debt financing; Beattie, Goodacre, and Thomson (2000); Rashid (2013) on risks and financing decisions in the
energy sector, and Yan (2006) on the lease-debt substitutability. However, our understanding of the capital structure decisions of firms is mainly based on non-financial firms. Yet, financial firms including banks are also important.

Financial intermediaries play an important role in enhancing economic activities by facilitating the borrowing and lending opportunities in an economy. Therefore, it is worth exploring to know as to how the financial firms, particularly the commercial banks, determine their capital structure. The studies exploring capital structure of commercial banks have identified several bank-specific factors that are important in explaining capital structure choices of conventional commercial banks. However, these studies have left two gaps in the literature. First, most of prior studies on the capital structure decisions in banking sector have focused on developed countries. Therefore, we know relatively less as to how the capital structure of banking sector in developing countries is determined. Second, none of the empirical studies has examined this issue for Islamic banking. As a result, our understanding of capital structure decisions in banking sector remains incomplete.

Several studies, such as Hook and Tang (2010), Levy and Hennessy (2007), Hackbarth, Miao and Morellec (2006), Korajczyk and Levy (2003), and Shleifer and Vishny (1992) have examined the impact of macroeconomic conditions on capital structure decisions of non-financial firms. However, only a few studies, for example, Alper and Anbar (2011), Bellinetti (2009), and Antoniou, Guney and Paudyal (2008), have examined the impact of macroeconomic factors on the capital structure decisions of banks.

The main objective of this study is to explore the determinants of capital structure in the Islamic banking industry of Pakistan. The study also aims at exploring the effects of macroeconomic conditions and policy variables, namely interest rates and taxes on the financing decisions of Islamic banking industry.

**The study attempts to seek the answer of the following question:**

1. What are the determinants of capital structure of the Islamic banking industry in Pakistan?

2. Do macroeconomic conditions and policy variables affect the capital structure of Islamic banking industry?

In Pakistan, Islamic banking industry started from scratch in 2002 and now it constitutes over 8 percent of the country’s banking system with a network of 1783 branches and over 500 windows across the country as of September 30, 2015. The future outlook is also very positive. The Islamic financial industry with its rapidly growing acceptability both among the providers and users of financial services is likely to increase its share in the banking system to 15 percent during next five years (2013-2017). Encouragingly, the sustained growth of Islamic banking in the country during the last decade has also started catalyzing growth and development of Islamic capital markets, Mutual funds and Takaful companies etc. Presently, we have 5 Takaful operators and about 30 Islamic mutual funds.¹

¹ Islamic Banking Billiton (September 2015) published by State Bank of Pakistan.
2. REVIEW OF LITERATURE

This section is divided into three segments. The first part deals with theories of capital structure, while the second part addresses prior studies related to capital structure decisions. The final and third part discusses the important variables explored in the previous studies on capital structure.

2.1 Theories of Capital Structure

What are the determinants of a firm's capital structure choice? In the field of corporate finance, researchers have devoted extensive time both theoretically and empirically to answer this question. After the publication of seminal papers by Modigliani and Miller (1958, 1963), this question acquired a special significance. The determinants of capital structure have been investigated by several researchers. However, still there is no unifying theory of capital structure even after decades of serious research, which leaves the topic of capital structure open for further research. Capital structure is basically a mix of a company's debt and equity that it uses to finance its assets. It is necessary for every firm that the capital structure decision must be handled carefully otherwise the firm can face the problem of bankruptcy and financial distress.

A number of theories have been advanced to explain the capital structure of firms. However, a single theory is not able to explain the observed time series and cross section patterns of firms' capital structure. Below we briefly review the two fundamental theories of capital structure.

The Trade-Off Theory

The trade-off theory proposed by Modigliani and Miller (1963) explains that the most favourable level of capital structure can be determined by balancing the benefits and costs associated with debt financing. This would be more like a balance between tax shield from interest expense and the cost associated with financial distress. The trade-off theory of capital structure expects that organizations with better profitability should favour to exercise debt financing rather equity financing in order to take benefits from the tax shield.

Taxes, agency costs, and financial distress are the three main factors that influence a firm’s optimal capital structure according to the trade-off theory. Firms will use large amount of debt in their capital structure because debt provides them a tax shield, improving their profitability. However, using higher debt will increase bankruptcy costs. Thus, creditors will demand extra risk premium increasing costs of debt (Baxter, 1967).

The Pecking Order Theory

The second dominant theory regarding the capital structure of firms is the pecking order theory (Myers, 1984; Myers and Majluf, 1984). Asymmetric information problems arise in corporate finance when firm insiders have more information than people outside the firm such as investors or debt issuers (Myers and Majluf, 1984). The pecking order theory maintains that because of information asymmetries firms have a preferred sequence of financing. Firms will first seek to fund projects with internal funding (retained earnings or internal debt), move to external debt markets when internal funding
is not available, and, finally, raise funds in external equity markets when other funding resources have been depleted. There are multiple reasons for these preferences but they can be fundamentally thought of as ease of administration and an effort to limit the financial impact on equity holders (Turner, 2010).

### 2.2 Review of Prior Empirical Studies on Capital Structure

Banks’ capital structure fundamentally differs from the one of non-financial firms since it includes deposits, a source of financing generally not available to non-financial firms. Moreover, much of the empirical research for firms was performed using long-term debt divided by assets rather than total liabilities divided by assets. Therefore, bank liabilities can be decomposed into deposits and non-deposits liabilities. Non-deposit liabilities can be viewed as being closely related to long-term debt for firms (Gropp and Heider, 2010). The capital structure of banks is, however, still a relatively under-explored area in the banking literature. Thus, there is no clear understanding on how banks choose their capital structure and what factors influence their corporate financing behaviour. Houston, James, and Marcus (1997) found that lending at large banks is less subject to changes in cash flow and capital. Jayaratne and Morgan (1999) found that shifts in deposit supply affect lending at small banks that do not have access to the large internal capital market. Akhavein, Humphrey, and Berger (1997) also pointed out that large banks tend to decrease their capital and increase their lending after mergers. Bank size seems to allow banks to operate with less capital and, at the same time, engage in more lending (Amidu, 2007).

A significant relation of bank size, profitability, tangibility, and liquidity is found with the leverage. Non-tax shield is found to have a positive but insignificant relationship with the leverage of the banking sector of Pakistan (Ali, Akhtar, and Sadaqat, 2011). Gul, Khan, Razzaq, and Saif (2012) also provided the evidence of the capital structure theories pertaining to a developing country. Specifically, they examined the determinants of capital structure for the firms in the banking and insurance sectors of Pakistan. Doing so they find out the financial pattern of firms in these sectors and they identify the capital structure theory followed by the firms. They found that both the pecking order theory and the trade-off theory are pertinent theories to the companies’ capital structure, whereas there was little evidence to support the agency cost theory. One should note that the above-cited studies have focused on only conventional banks.

### 3. DATA DESCRIPTION AND EMPIRICAL FRAMEWORK

This section presents the empirical framework to examine how bank-specific and macroeconomic variables affect leverage decisions in Islamic banking sector. Econometric methods that are implemented to estimate the empirical model are also discussed in this section. Data and data sources are also described in this section.

#### 3.1 Description of Data

In this study, panel data are used to examine the capital structure decisions of Islamic banking industry of Pakistan. Specifically, quarterly panel data during the period
2006-2012 are taken from financial statements of ten Islamic banks (five full-fledged Islamic banks and five Islamic branches of conventional banks) practicing in Pakistan. The financial statements (disclosure) prepared by the banks are standardized according to the requirements of the central bank – the State Bank of Pakistan. Based on the requirements of the central bank, both conventional and Islamic banks follow the same accounting standards which make possible for analysis across banks and over time. Table 1 presents the name of the banks. Panel data involves the pooling of observations on a cross-section of units over several time periods and facilitates identification of effects that are simply not detectable in pure cross-sections or pure time-series studies.

Quarterly data of inflation are collected from the State Bank of Pakistan. Data on interest rate and IPI (Industrial Production Index) are collected from the International Financial Statistics (IFS) database by International Monetary Fund (IMF). We have used data of IPI instead of GDP, which is not available on quarterly basis in our analysis.

<table>
<thead>
<tr>
<th>Table 1: Sample of Selected Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic Banks</td>
</tr>
<tr>
<td>AlBaraka Bank (Pakistan) Limited</td>
</tr>
<tr>
<td>BankIslami Pakistan Limited</td>
</tr>
<tr>
<td>Burj Bank Limited</td>
</tr>
<tr>
<td>Dubai Islamic Bank Pakistan Limited</td>
</tr>
<tr>
<td>Meezan Bank Limited</td>
</tr>
<tr>
<td>Islamic Branches of Conventional Banks</td>
</tr>
<tr>
<td>Askari Bank Limited Bank</td>
</tr>
<tr>
<td>Alfalah Limited</td>
</tr>
<tr>
<td>Habib Bank Limited</td>
</tr>
<tr>
<td>MCB Bank Limited</td>
</tr>
<tr>
<td>Bank Al Habib Limited</td>
</tr>
</tbody>
</table>

3.2 Empirical Framework

The main objective of the study is to explore the determinants of leverage while examining the effects of bank-specific variables. We also include macroeconomic variables into the specification. Our choice of bank-specific and macroeconomic variables is based on prior empirical studies which examine the determinants of leverage in corporate firms, for instance, see Frank and Goyal (2009), Sayığan, Karabacak, and Küçükkocaoğlu (2006) and in conventional banks, for instance, see Amidu (2007) and Gropp and Heider (2010). In particular, we estimate the following model.

\[
\text{Lev}_{it} = \beta_1 + \beta_2 \text{Size}_{it-1} + \beta_3 \text{Profit}_{it-1} + \beta_4 \text{Tang}_{it-1} + \beta_5 \text{Liq}_{it-1} + \beta_6 \text{NDTS}_{it-1} + \beta_7 \text{CAR}_{it-1} + \\
\beta_8 \text{Grw}_{it-1} + \beta_9 \text{ERIR}_{it-1} + \beta_{10} \text{Inf}_{it-1} + \beta_{11} \text{In(IPI)}_{it-1} + \varphi \ell + \mu_{it} \quad \text{eq (1)}
\]
In Eq (1) the subscript “i” represents the cross-sectional dimension and “t” denotes the time-series dimension. The left-hand (dependent) “Lev” is leverage, which is defined as: leverage = 1- (book value of equity/book value of assets). The argument for using leverage rather than debt as the dependent variable is that leverage, unlike debt, is well defined in banking sector because a bank’s capital structure is different from non-financial firms’ capital structure since it includes deposits, a source of financing generally not available to firms. This fundamental difference decomposes bank liabilities into deposit and non-deposit liabilities. Moreover, leverage is defined as one minus the equity ratio; the dependent variable can be directly linked to the regulatory view of banks’ capital structure (Gropp and Heider, 2010). We can derive the equation of leverage from a typical capital structure equation.

\[ BVA = BVD + BVE \]

where BVA is book value of asset, BVD is book value of debt, and BVE is book value of equity.

Dividing by BVA, both sides of equation

\[ \frac{BVA}{BVA} = \frac{BVD + BVE}{BVA} \]

\[ 1 = \frac{BVD}{BVA} + \frac{BVE}{BVA} \]

Where,

\[ \text{Leverage} = \frac{BVD}{BVA} \]

Hence,

\[ \text{Leverage} = 1 - \frac{BVE}{BVA} \]

The right-hand variables “Size” is bank size and defined as logarithm of total assets normalized by consumer prices index (CPI), “Profit” is profitability, which is defined as return on assets, “Tang” is tangibility, that is defined as the ratio of fixed operating assets to total assets, “Liq” is liquidity, which is defined as the ratio of capital to total assets, “NDTS” is non-debt tax shield that is defined as the ratio of depreciation expenditures to total assets, “CAR” is capital adequacy ratio prudentially required to comply with the capital adequacy framework of the State Bank of Pakistan, “Grw” is growth defined as annual percentage change in logarithm of total assets, “RIR” is the real interest rate, “Inf” is inflation, which is defined as log difference between CPI of current and previous year, “IPI” is the log of industrial production index, “b” is bank-specific fixed effects and “µ” denotes error term.
3.3 Estimation Methods: Fixed versus Random Effects Models

In panel data, two basic approaches, fixed-effects and random-effects models are applied generally. In order to identify whether fixed or random effects estimator provide more efficient estimates we apply the Hausman’s (1978) specification test.

Based on the results of the Hausman’s (1978) specification test we select fixed effects model because the estimated value of chi-squared is greater than critical value at the 5% level of significance. Therefore, we apply the fixed effects estimator in our empirical analysis.

4. EMPIRICAL RESULTS

Fixed-effects model is selected to analyze the impact of bank-specific and macroeconomic variables on the leverage of Islamic banking industry. The results are presented in Table 2. The results strongly indicate that Islamic banks significantly take into consideration both bank-specific and macroeconomic variables when they decide on their optimal level of leverage. The results of both the bank-specific and macroeconomic variables are elaborated separately in the following section.

Size

The results indicate a statistically significant positive relationship between bank size and the leverage decisions of the bank. Specifically, the results suggest that the bigger the bank, the higher the leverage ratio. That is, large bank are more likely to use debt in their capital structure. This result supports the trade-off theory and is consistent with the empirical evidence reported in Frank and Goyal (2009), Kayhan and Titman (2007), Rajan and Zingales (1995), and Saeed (2007). These studies have also reported a positive and statistically significant relationship between size and leverage. Concerning banks’ capital structure, studies such as Gropp and Heider (2010) and Ali, Akhtar, and Sadaqat (2011) have also reported the positive impact of bank size on the leverage of banks.

Profitability

The estimates regarding profitability show a negative relationship between the banks’ profit and leverage. This negative association suggests that profitable banks are likely to use less debt in their capital structure. The impact of profitability on leverage is consistent with the Myers’ (1984) prediction that successful companies do not need to depend so much on external resources to finance their capital needs. They, instead, rely on their internal reserves accumulated from past profits. Most of the previous empirical studies found a negative relationship between profitability and debt financing. Examples of these studies are Myers (1984), Sayılgan, Karabacak and Kıcıkkocaoglu (2006), Shah and Khan (2007), and Frank and Goyal (2009). Similarly, studies like Booth (2001), Gropp and Heider (2010), Ali, Akhtar, and Sadaqat (2011), and Ali (2011) have also documented a negative relationship between debt and profitability in financial sector.
Tangibility

In line the trade-off theory, the coefficient of tangibility is positive, suggesting that the amount of fixed assets (buildings, furniture, machines, and land) is effective for enhancement of debt financing. Banks can easily achieve funds for structuring their capital because fixed assets are good securities to fund providers. Our finding for tangibility is generally consistent with the previous empirical work including studies of Titman and Wessels (1988), Margaritis and Psillaki (2007), Frank and Goyal (2009), Shah and Khan (2007), Huang and Song (2006), Fauzi and Locke (2012), and Ali, Akhtar and Sadaqat (2011) that have found a positive relationship between tangibility and leverage.

Liquidity

Regarding the impact of liquidity on the leverage decisions of Islamic banking industry, the results presented in the Table 2 suggest that there is a negative and statistically significant relationship between liquidity and leverage. This negative impact is consistent with the pecking order theory, which predicts a negative association between liquidity and leverage because high liquidity firms can generate sufficient cash inflows and therefore the excess cash inflows can be used to finance investment and operating activities. Most of the previous empirical studies also found a negative relationship between liquidity and debt financing (Ali, Akhtar, and Sadaqat, 2011; Taleb and Shubiri, 2007; Gul, Khan, Razzaq, and Saif, 2012).

Capital Adequacy Ratio

Our results also suggest that capital adequacy ratio has a significant impact of the leverage decisions of Islamic banks. As capital holding bears a substantial cost, therefore, bank’s management tries to hold less capital than required by central bank (Mishkin, 2000). Our finding is in line with the previous findings which also have explored a negative relationship between capital adequacy ratio and leverage. Grais and Anoma (2006) have explored that the banks hold a minimum amount of capital, based on the risk embedded in their asset holding. Accordingly, banks with relatively risky assets in their operations would hold a higher amount of capital than those banks with less risky assets.

Growth

We find that the growth and leverage decisions are significantly and positively correlated in Islamic banking industry of Pakistan. Thus, this result supports the pecking order theory, which predicts that the growth of a firm and its use of debt are positively related. The reason is that debt has no asymmetric problems therefore when outside funds are needed firms will go for debt against equity because for a growing firm their internal funds might not be sufficient to meet their requirements, therefore they will require more funds to spend on research and development in order to expand their business and to finance their positive investment projects. Our finding for growth is generally consistent with the previous empirical work. Gul, Khan, Razzaq, and Saif (2012) and Bellinetti (2009) have found that the debt level and growth were significantly positively correlated banking in banking sector.
The empirical evidence supports a negative relationship of real interest rate with significant effect upon leverage in line with Korajczyk and Levy (2003) assumptions, of the negative correlation. Ariccia, Laevena, and Marquez (2013) have also explored that banks can adjust their capital structures with reductions in real interest rates. The decline in real interest rate leads to greater leverage and higher risk for any downward sloping loan demand function.

### Table 2: Estimates for Islamic Banking Industry’s Leverage

<table>
<thead>
<tr>
<th>Regressors</th>
<th>Coefficient</th>
<th>t-statistics</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Estimation results</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size</td>
<td>0.026</td>
<td>4.6***</td>
<td>0.000</td>
</tr>
<tr>
<td>Profitability</td>
<td>-0.128</td>
<td>-2.7***</td>
<td>0.006</td>
</tr>
<tr>
<td>Tangibility</td>
<td>0.678</td>
<td>1.9**</td>
<td>0.053</td>
</tr>
<tr>
<td>Liquidity</td>
<td>-0.582</td>
<td>-12.7***</td>
<td>0.000</td>
</tr>
<tr>
<td>NDTs</td>
<td>6.986</td>
<td>1.6*</td>
<td>0.110</td>
</tr>
<tr>
<td>CAR</td>
<td>-0.002</td>
<td>-2.9***</td>
<td>0.003</td>
</tr>
<tr>
<td>Growth</td>
<td>0.001</td>
<td>3.1***</td>
<td>0.002</td>
</tr>
<tr>
<td>Real Interest Rate</td>
<td>-0.003</td>
<td>-1.3*</td>
<td>0.177</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.003</td>
<td>-1.7*</td>
<td>0.075</td>
</tr>
<tr>
<td>IPI</td>
<td>0.036</td>
<td>0.7</td>
<td>0.428</td>
</tr>
<tr>
<td>Constant</td>
<td>0.351</td>
<td>1.4</td>
<td>0.158</td>
</tr>
</tbody>
</table>

**Panel B: Basic Information**

**Fixed-effects (within) regression**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>Number of observations</td>
<td>238</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of groups</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$R^2$: within</td>
<td>0.842</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Between</td>
<td>0.565</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>0.7115</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F-Statistics</td>
<td>116.39 (0.00)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Panel C: Diagnostic Tests**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>sigma_u</td>
<td>0.062</td>
<td></td>
<td></td>
</tr>
<tr>
<td>sigma_e</td>
<td>0.043</td>
<td></td>
<td></td>
</tr>
<tr>
<td>rho</td>
<td>0.675</td>
<td>(fraction of variance due to $u_i$)</td>
<td></td>
</tr>
</tbody>
</table>

F test that all $u_i=0$:  
F(9, 218) = 6.12  
Prob> F = 0.000

***, **, * represent statistical significance at the 1%, 5%, 10% levels, respectively.

### Real Interest Rate

The empirical evidence supports negative relationship of real interest rate with significant effect upon leverage in line with Korajczyk and Levy (2003) assumptions, of the negative correlation. Ariccia, Laevena, and Marquez (2013) have also explored that banks can adjust their capital structures with reductions in real interest rates. The decline in real interest rate leads to greater leverage and higher risk for any downward sloping loan demand function.
Inflation

The empirical evidence supports negative relationship of Inflation with significant effect upon leverage. The empirical result also supports partially Gajurel (2006) who concluded that the inflation rate is negatively related to total debt ratio and short-term debt ratio, whereas, it is positively related to long-term debt ratio. It implies that increasing inflation supports to increase long term debt and decrease short-term debt. To some extent, in short-run, the higher inflation decreases the interest rate, which could foster long-term borrowing.

Industrial Production Index

We observed that the relationship of Industrial Production Index with leverage is positive. Yet it is insignificant statistically. Similar to our finding, Gajurel (2006) has also showed that the GDP growth rate is positively related to long-term debt ratio, whereas, it has a negative relationship to total debt ratio and short-term debt ratio. In other words higher economic growth means more long-term debt and less short-term debt.

Overall, our results regarding the role of bank-specific variables on leverage are in line with the literature. Hence, we do not further comment on these variables.

5. CONCLUSION AND RECOMMENDATION

A number of financial facilities are offered in corporate and retail banking sectors of Pakistan. Offering several financial products and services, banking sector of Pakistan significantly serves the economy of the country. Since 2002, Islamic banking industry is growing rapidly and now its share is over 8 percent of the country’s banking industry as of June 30, 2013. This study builds a framework for analyzing the capital structure decisions of the Islamic banking industry in Pakistan. For empirical analysis, the study uses quarterly panel data covering the period from 2006-2012. The fixed-effect estimator is used to estimate the empirical model.

The empirical results of the study reveal that bank-specific variables, namely bank size tangibility, and growth are positively related to the capital structure decisions of Islamic banking industry, whereas, the profitability of banks, liquidity, and the capital adequacy ratio (CAR) are negatively related to the capital structure decisions. These findings suggest that bank-specific variables play a significant role in explaining the capital structure decisions of Islamic banks in Pakistan. The results also suggest that non-debt tax shield (NDTS) does not have a significant impact of Islamic banks’ capital structure decisions. On the other hand, the results pertaining to macroeconomic variables indicate that both the real interest rate and inflation are negatively related to banks’ leverage, while industrial production index (IPI) is positively and statistically significantly related to the capital structure decision of the Islamic banking industry of Pakistan during the examined period. The results presented in this study are generally consistent with the theories developed in finance to explain capital structure, including the trade-off theory and the pecking order theory of capital structure.

There could be several recommendations based on our empirical analysis that might be useful for capital structure and other financial decisions of Islamic banks in
Pakistan. The results of the study would help bank managers, investors, and customers to understand how banks’ capital structure decisions respond to bank characteristics and macroeconomic conditions. The results also suggest that the central bank should respond to motivate economic changes when choosing their policy stance as macroeconomic conditions leave a significant impact of banks’ capital structure decisions. Capital adequacy ratio (CAR) is especially analyzed to explain the banks’ leverage and appeared as a significant potential variable which is a good guide for risk management while enforcing minimum capital requirements. It is also important for bank supervisors to bear in mind while assessing the safety and soundness of banks. The study recommends that macroeconomic policy variables might be considered by the board of directors of the commercial banks while deciding capital structure. There is a need to devise Islamic instruments at the end of State Bank of Pakistan as currently Islamic banks are compensated against statutory liquidity ratio (SLR) by maintaining smaller than conventional banks. Although certain proportion of demand and time liabilities can be invested in Sukuk, yet Islamic banks cannot earn profit on statutory liquidity reserves and remain disadvantaged as compared to conventional banks.

During the course of research, a number of exogenous factors came to the knowledge of researchers. One, being important from viewpoint of banks capital structure appears to be the varied and diversified Sharia verdicts (Fatawa) around the globe. There is need that harmonization in this respect should be achieved to strengthen building capital structure of Islamic banking industry. Accounting and Auditing Organization of Islamic Financial Institution (AAOIFI) and Islamic Financial Services board (IFSB) can play a significant role in this respect.

The study has utilized fixed effect model while explaining the impact of bank-specific and macroeconomic variables on capital structure decisions. However, for future work, a dynamic model of leverage can be formulized and Generalized Method of Moments (GMM) estimator can be used. System GMM estimator effectively mitigates the problem endogeneity as well. A comprehensive analysis can be done using the country level panel data. The impact of global variables such as world GDP and trade openness can also be examined in the future.

REFERENCES


Book Review

**Title:** Readings in Microeconomics: An Islamic Perspective.

**Editor(s):** Sayyid Tahir, Aidit Ghazali, Syed Omar Syed Agil.

**Publisher:** Longman Malaysia.

This book is a compilation of some of the seminal contributions in Islamic economics literature on the micro foundations of economics from an Islamic perspective. The book puts together some significant works which are unique in many respects in building the theoretical foundations of Islamic Economics. It assembles 7 chapters on consumer behaviour, 4 chapters each on producer behaviour and market structure and 3 chapters each on resource allocation and distribution.

The first two parts of the book look at the behaviour of economic agents, i.e. consumers and producers. The section on consumer behaviour emphasizes on the moral underpinning of Islamic teachings which govern the consumer choice set, shape preferences and influence behaviour and choices. The chapters use the mainstream economics tools such as indifference curves and differential analysis in the utility framework to provide contrast between mainstream economics and Islamic perspective. The goals in Islamic economics center on human *Falah* (all encompassing moral and spiritual wellbeing) than focused on some material end alone. The choice set in Islamic framework also does not incorporate consumer sovereignty. Rather, the Islamic teachings provide guidance to Muslims in order to differentiate between *Tayyabât* (morally good things) and *Khabâís* (morally bad things) and between *Halâl* (lawful) and *Harâm* (unlawful) in consumer choice set. Among the *Halal* consumption as well, Islamic teachings guide towards *Wasatiyyah* (moderation) and to avoid *Iṣrâf* and *Tabzeer* (excess and wasteful consumption). Instead of encouraging towards consumption on self, the Qur’anic use of the word spending is profound. It simultaneously incorporates the expenditure on self, others and in the way of Allah with single word. Islamic principles have a transformative content rather than serving material instincts or arousing them. This is reflected in Islamic teachings which emphasize the need for spending not on self and one’s household only, but also on others and in the way of Allah. These actions are completely rational within the Islamic worldview where the ultimate objective is to earn

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*Book Reviewed by Salman Ahmed Shaikh is pursuing PhD Economics at National University of Malaysia. E-mail: salman@siswa.ukm.edu.my*
Falah in both this world and in life hereafter. Economic wellbeing can be a cherished sub-goal as long as it is consistent and contributes to the moral and spiritual wellbeing. The section on producer behaviour also emphasizes the moral content in behaviour whether it is with regards to pricing, advertising or with regards to using natural and non-natural resources in production. Since Islam prohibits Riba (interest), the capital shall be rewarded from the actual profits rather than be compensated with a fixed return for its use regardless of the outcome of the production process. The section also emphasizes that profit maximization shall not breach the Islamic moral choices. The profit motive shall remain a secondary consideration alongwith seeking conformity with Islamic principles and teachings which govern the pursuit of Halal income from the productive enterprise.

The section on market structure emphasizes that Islam does not negate private property and private pursuit of economic enterprise. It does not necessarily favour centralization of production activity. However, the papers in this section emphasize that Islam promotes co-operation rather than competition. The concept of cooperation also implies that market power in monopoly and other less-competitive market structures shall not be used to exploit either the consumers or the producers. The papers also give an account of how some of the concepts related to market structure and market forces have been dealt with by early Muslim writers before the publication on wealth of nations by Adam Smith.

The sections on resource allocation and distribution emphasize that resource allocation at micro and policy level shall also take Maslaha (social and spiritual welfare) into consideration. The income distribution in Islamic framework is distinguished from both Capitalistic and Marxist framework. The Marxist framework is critically analyzed and it is argued that Islam does not negate individual differences in remuneration if these are based on lawful earnings and which arise from superior skills or other factors. However, Islamic framework negates the extractive institutions which worsen the income distribution, such as fixed return to money capital. By prohibiting fixed return to money capital and by levying a charge in idle wealth as Zakāt, Islam encourages either lawful spending or lawful investments in productive enterprise through risk sharing arrangement. Both these features keep the resources circulating in the economy. This can help in avoiding the unwanted situation of idle resources existing with unmet needs as is the case in the present market economy framework of capitalistic economies.

Overall, the book is a significant effort to develop the theoretical literature on Islamic economics in unique ways. The papers are substantive in analytical content. The use is made of mainstream economics tools such as indifference curves, differential calculus, demand-supply cross, mainstream production and costs graphs and edge worth box, for instance in presenting the ideas from an Islamic perspective. If more focused research is undertaken in this area, then Islamic economics can become an established analytical discipline. This book is a significant addition in the literature on Islamic economics and can be used as a reference text in courses related to Islamic economics.
Country Model

Kenya

Islamic banking started in Kenya in 2005 with Barclays launching Islamic banking products in December, 2005. Subsequently, two Islamic banks; the First Community Bank and Gulf African Bank started their Islamic banking operations in 2007 and 2008, respectively. Currently, some conventional banks are also offering Islamic banking products and services in the country through Islamic banking windows.

In last few years, the country has introduced several regulatory reforms to facilitate Islamic finance including rules for Islamic Real Estate Investments Trust (REIT) and rules creation of Takaful windows. Further, the country is in process of establishing an Islamic Finance Project Management Office (PMO) to develop an institutional, policy and regulatory framework for the Shariah compliant Islamic finance industry.

Legal & Regulatory Framework for Islamic Banks

The Central Bank of Kenya (CBK) regulates both conventional and Islamic banking institutions through a single regulatory framework and Islamic banking activities fall under framework of the Banking Act and the CBK Act. The CBK made some amendments in its Banking Act in 2008 and included provisions for banks to offer Islamic banking products through full-fledged Islamic banks or windows. The amendment also included a clause to recognize 'returns' as consideration for money lent/borrowed, as opposed to 'interest'. The CBK has also exempted Islamic banking institutions from provisions of the act that restrict trading/investment activities.

Way Forward

The country is making efforts to provide supportive environment for development of Islamic finance in the country. Hence, with an increased focus of Islamic banking and finance complemented with a sizeable Muslim population, Kenya has potential to create an important place for itself in the African Islamic banking and finance industry in the coming years.

Sources of Information

- Islamic Finance Advisory Assurance Services (IFAAS) [http://uk.ifaas.com/](http://uk.ifaas.com/)
- Global Islamic Finance Report (various editions), Edbiz Consulting Limited, UK
- Central Bank of Kenya website [https://www.centralbank.go.ke/](https://www.centralbank.go.ke/)
- [www.islamicfinancenews.com](http://www.islamicfinancenews.com)

* Source: State Bank of Pakistan, Quarterly Islamic Banking Bulletin Oct-Dec 2016
# Islamic Capital Market Indicators

<table>
<thead>
<tr>
<th>Measures / Groups</th>
<th>Annualized Return (%)</th>
<th>Annualized S.D (%)</th>
<th>Coefficient of Variation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic</td>
<td>07-16 07-10 11-16</td>
<td>07-16 07-10 11-16</td>
<td>07-16 07-10 11-16</td>
</tr>
<tr>
<td>Islamic 07-16 07-10 11-16</td>
<td>07-16 07-10 11-16</td>
<td>07-16 07-10 11-16</td>
<td>07-16 07-10 11-16</td>
</tr>
<tr>
<td>S&amp;P Developed Shariah</td>
<td>6.24 1.65 8.53</td>
<td>17.42 23.47 13.41</td>
<td>2.79 14.25 1.57</td>
</tr>
<tr>
<td>S&amp;P Global Shariah</td>
<td>5.74 1.63 7.79</td>
<td>17.23 23.41 13.10</td>
<td>3.00 14.36 1.68</td>
</tr>
<tr>
<td>S&amp;P Emerging Shariah</td>
<td>1.36 2.36 0.85</td>
<td>20.04 28.20 14.33</td>
<td>14.78 11.92 16.82</td>
</tr>
<tr>
<td>S&amp;P Europe 350 Shariah</td>
<td>8.05 4.94 10.03</td>
<td>19.14 23.61 15.64</td>
<td>2.38 4.78 1.56</td>
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<td>Conventional</td>
<td>07-16 07-10 11-16</td>
<td>07-16 07-10 11-16</td>
<td>07-16 07-10 11-16</td>
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Source: SP Dow Jones Indices
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