Journal of Islamic Banking & Finance

Global Perspective on Islamic Finance

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Sura Ale-Imran (verse No. 130)

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Editor’s Note

The size of the global Islamic banking assets has crossed the mark of $2.0 trillion. Resilience in growth, effective risk management and participative modes of financial products has enabled Islamic finance to play a significant role in the Muslim economies.

Islamic finance has some latent potential which has started to be comprehended more clearly in recent times. Risk-sharing in Islamic finance shifts the emphasis from credit-worthiness of the borrower to the value creation and economic viability of investments that create new wealth. High levels of debt in the conventional interest-based financial architecture are one of the prime causes of repeated financial crises. This has been well documented now after the great financial crisis of 2007-09.

Furthermore, real sector based productive enterprise in Islamic finance has positive implications for the ecosystem. Islamic finance can contribute to sustainable economic development through widening access to finance (including microfinance), financing infrastructure projects, and expanding the reach of Takaful (Islamic insurance).

As part of its commitment to the Sustainable Development Goals (SDGs), the Islamic Development Bank has announced that it will increase its funding of SDG related activities through its ten-year strategy framework, from $80 billion recorded during the MDGs, to $150 billion over the next 15 years (2016-2030). As per Islamic Development Bank, innovative Islamic financial instruments, especially for infrastructure development such as Sukuk, can be used to mobilize resources to finance water and sanitation projects (SDG-6), sustainable and affordable energy (SDG-7), build resilient infrastructure (SDG-9) and shelter (SDG-11).

The success of achieving the SDGs depends on infrastructure development, inclusive growth, employment creation, environment-friendly technological advancements and business processes re-engineering. This requires substantial mobilization of funds through financial institutions and in financial markets. According to some estimates, around $3.5 trillion to $5 trillion is needed every year to make desirable progress on SDGs. At the global level, investment in infrastructure is estimated to be US$ 100 trillion over the next two decades. Islamic finance can play a key role in bridging the finance gap, especially in the Muslim world.

On the retail side, there is still significant room for growth. A study by Islamic Development Bank uses UN-Habitat 2006 methodology and the estimates suggest that the IDB member countries need around 8.2 million houses per year to accommodate poor and low-income urban people. This translates into nearly 22,421 dwellings per day in
order to accommodate the expected urban population growth. Thus, this presents a
challenge as well as an opportunity for Islamic banks to increase their outreach by
extending their product line and geographical presence towards fostering inclusive
finance in OIC countries.

Finally, another key driver for Islamic finance is financial inclusion to tap the
unchartered market. Islamic finance can help in enabling access to financial services for
people who want Islamic financial services. The key question is that can Islamic finance
also provide access to financial services to the bottom of the pyramid population.
Financial inclusion of the poor requires a different approach in product design, pricing
and delivery. This requires innovation, flexibility, efficiency and committed leadership.
Islamic microfinance is yet to take big strides. Going forward, Fintech offers an
opportunity for Islamic financial institutions to efficiently reach the potential clients.
Fintech can help in increasing Islamic finance outreach in regions where brick-and-
mortar model of delivery will not be financially sustainable.

So we see the scope and potential of Islamic finance increasing providing ample
opportunities for 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.

“Sukuk: A Development Vehicle with Investment Security” paper is written by
Mohd Ma’Sum Billah, he says in this article that Sukuk, is the Shari’ah alternative to the
bond practiced in the modern capital market. It had been significantly expanded for the
last more than a decade by attracting both Muslim and non-Muslim participants with
promising results. The Securities commission’s guidelines provide that, Sukuk refers to
certificates of equal value which function as an evidence of undivided ownership or
investment in the assets using Shariah principles and concepts endorsed by the Shariah
Advisory Council Thus, an attempt is made in this paper to scrutinize the model of Sukuk
as an investment security by complying the Shari’ah spirit and standard as to universal
value.

In their article “Islamic Banking and Finance in North Africa: An Extensive
Review” Abdelghani Echchabi, Assistant Professor, A’Sharqiyyah University in Oman,
College of Business Administration, Department of Accounting and Finance and Dhekra
Azouzi, Ph.D Candidate, El-Manar University Tunisia, Faculty of Economic Sciences
and Management, Department of Finance and Accounting, look at the Islamic Banking
industry in North African countries. Their article is based on library research to uncover
status of current IB industry and empirical research done in Tunisia, Libya, Egypt and
Sudan. They conclude that more empirical, multidimensional research is required, if
North African countries are to develop their Islamic Banking systems.

“The Impact of Selected Macroeconomic and Bank Specific Determinants on
Islamic Deposits in Malaysia” contributed by Abdullah Ludeen, PhD Researcher in
Islamic Finance, Global University of Islamic Finance (INCEIF) attempts to empirically investigate whether the determinants of deposit in Islamic banks are significantly different from their conventional counterparts. He uses an ARDL approach and ECM model to determine this issue while time series data from Malaysian banking system is used for analysis. His research results indicate that among the macro-economic variables, industrial production index (GDP Growth) has strong impact on Islamic banking deposits while inflation (CPI) does not have a significant impact. Among the bank-specific variables both interest rate and profit rate have strong impact on Islamic deposits. However, the most relevant finding from policy perspective is that depositors of Islamic banks in Malaysia being both Muslims and non-Muslims, are profit conscious and any reduction in profit sees the transfer of deposits from Islamic to Conventional banks.

“Bank Efficiency: Islamic and Conventional Banks in Malaysia”, contributed by Athirah Safea Jamaluddin, Nor Najwa Hanani Ilyas Syukriah Ali, Najah Mokhtar and Kartini Kasimnks is based on their study of 15 Islamic and 27 conventional banks in Malaysia. This group of graduate students and faculty from Universiti Teknologi, in Malaysia, through use of statistical modeling and a study of previous similar studies attempted to determine if the banks efficiency is impacted by any one of five variables - Level of Capitalization (CPT), Credit Risk (CR), Riskiness of Bank (RB), Return on Asset (ROA) and Bank Size (BS)and if there is a difference of such impact between conventional and Islamic Banks. The research team concluded that indeed all five factors impact on the efficiency of Islamic Banks while the conventional banks efficiency is impacted by only four of the above factors, Credit Risk being the factor which is less impactful here.

Manzar Ali Khan, Nazimah Hussin, Wan Khairuzzaman Wan Ismail and Jihad Mohammad all associated with the International Business School, Universiti Tecknologi Malaysia in Kuala Lumpur, in their paper “A Conceptual Framework and Propositions for The Adoption of Islamic Banking Services in India” propose a conceptual framework to identify factors that influence the intention to adopt Islamic banking services in India. Their study employs the decomposed theory of planned behaviour (DTPB) proposed by Taylor and Todd (1995a) to investigate the influence of perceived attributes of intention to adopt Islamic banking services. The study also intends to incorporate ethical judgement into DTPB model and investigate its influence on the intention to adopt Islamic banking services. Further, this study also examines the mediating effect of the ethical judgement on the relationship between the moral obligation, perceived consequences and the intention to adopt Islamic banking services. Basically they are exploring consumer behaviour and the aspects of it that influence buying behaviour for Islamic Banking services. It is an interesting study which needs to be taken further to establish such aspects to be used by IBs towards inducing potential clients to bank with them.

The article entitled “Putting Social Justice First: The Case of Islamic Economics” contributed by Asad Zaman, VC, Pakistan Institute of Development Economics and Junaid Qadir, Assistant Professor, IT, University of Punjab, Lahore, make a very good case for Islamic Economic system as being the only way to address inequality of wealth in the world. They present that western economic theory and ensuing practice leads to the rich getting richer and the poor poorer. The welfare state,
presented in Islamic economic teaching (derived from the Quran and Hadith), if adopted can lead to addressing many of the economic woes facing the world today.

Readers Comments

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  “Received the online copy of the latest issue of the Journal. Masha Allah there is improvement in the content and presentation with each issue. Congratulations.”

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The opinions, suggestions from our worthy readers are welcome, may be communicated on

E-mail: ia_ib@yahoo.com, Facebook: http://www.facebook.com/JIBFK, Website: www.islamicbanking.asia
Sukuk: A Development Vehicle with Investment Security

By
Mohd Ma’Sum Billah, PhD

Abstract

Sukuk, is the Shari’ah alternative to the bond practiced in the modern capital market. It had been significantly expanded for the last more than a decade by attracting both Muslim and non-Muslim participants with promising results thus, placing it to occupy more than 70% of the total Islamic financial market across the contemporary world. Policies, strategies, instruments, mechanisms, structures, marketing, management and operation are strictly ruled out to be in total compliance with the divine ethics and the principles of Shari’ah, which are closely monitored by the qualified Shari’ah scholars as to compliance with Shari’ah standard. The Securities commission’s guidelines provide that, Sukuk refers to certificates of equal value which function as an evidence of undivided ownership or investment in the assets using Shariah principles and concepts endorsed by the Shariah Advisory Council. Thus, an attempt is made in this paper to scrutinize the model of Sukuk as an investment security by complying the Shari’ah spirit and standard as to universal value.

Keywords: Sukuk, investment, Shari'ah

JEL Classification Code: G11, G14, G15, G32, G39, P51

Phenomena

Under modern practices, a bond is a debt security, which vests the holder with a right of a financial claim on the issuer. This claim protects the holder in circumstances in

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which the issuer is unable to pay the amount due. Bond bears certain similarities to saving account. When an investor deposits money in a saving account, in effect, that the investor is lending the bank money. The bank pays the investor interest on the deposit. Similarly, the investor who subscribes bonds lends the issuer money in return for interest. When the bonds mature, the investor will receive the principle amount of the bonds back, as he would have if he had withdrawn the amount from the saving account.\textsuperscript{4} In this case the bond functions as a securitization. The major difference between saving account and bonds is that investors can dispose their bonds in the secondary market before they are matured to the end investors. Savings accounts on the contrary can neither be sold in secondary market nor be disposed to other investors.\textsuperscript{5}

The formality for an enforceable bond with relevant documentations is required to specify the terms for both interest and principal payments. Interest can be paid monthly, bi-annually or yearly. This makes a difference to the compounding of the interest and will affect the trading of a bond. Most bonds are paid with bi-annually with agreed interest. in North America. "Eurobonds", which trade in Europe, are paid with interest annually. Mortgage-Backed Securities (MBS) and Asset-Backed Securities (ABS) are paid with monthly with agreed interest., reflecting the payment terms of the underlying mortgages and loans. The currency of payments is important. Some bonds have the coupon paid in one currency and the principal in another. Bonds which pay part of their principal before maturity are said to "amortize" their principal, this is the case with many mortgage bonds practiced in North America in particular.\textsuperscript{6}

It is noted here that, the bond market is categorized into two namely: the primary market and the secondary market. The primary bond market is where the bonds are initially issued, while the secondary market where the bonds are resold to other investors. Islamic bonds also share the similarities with the modern practices conceptually by adapting primary and secondary markets as well, but practically they are contracting each other as to principles, technicalities, issuance and trading.

Sukuk is governed by the Shari‘ah principles as an alternative to the bond practiced under modern economy. Sukuk is a financial instrument (document or certificate), which evidences the undivided pro-rata ownership of underlying assets. Sukuk is an Arabic term derived from ‘Sak’ (singular of Sukuk), which literally means ‘freely tradable at par, ‘premium or discount’.\textsuperscript{7}

The conceptual background of Sukuk typically involves the structuring of pools of Shari‘ah compliant assets or without credit enhancement into securities. It is structured based on specific contract of exchange that can be made through sales and purchase of an asset based on deferred payments, leasing of specific asset or participation in joint

\textsuperscript{4} Muhammad al-Bashir Muhammad al-Amine (2001), “The Islamic Bonds Market: Possibilities and Challenges”, in International Journal of Islamic Financial Services Vol. 3 No.1

\textsuperscript{5} Eswe Faerber (1993), All About Bonds and Bond Mutual Funds, Mc Graw Hill at Pp 3-9.

\textsuperscript{6} Ibid

\textsuperscript{7} Id
venture businesses. The issuance of Islamic bonds requires an exchange of a Shariah compliant underlying assets for a financial consideration through the application of various Shariah instruments namely: *ijarah* (leasing), *mudharabah* (co-partnership), *musharakah* (partnership) and or others. The structure of Sukuk has to be approved by the Shariah advisors to ensure that the structures are in compliance. In addition the structuring process may also involve the provision of additional protection for investors against late payments, Pre-payments, potential write-off and others. Such protection is often provided in the form of credit and/or liquidity enhancement scheme.8

In the process of Sukuk issuance, the doctrine of *Tawarruq* (special purpose vehicle) is used to securitize the instrument in the primary market, while in the secondary market, bay’ al-Dain is used in order to legalize reselling of the bonds. Such process is mostly used in the Malaysian market, while most of the Middle-Eastern countries do not accept it. The proposed alternative is Islamic bonds based on *Muqaradah* (profit sharing).

### Sukuk (Islamic Bond) Market

Considering the fact that bond issuance and trading are important means of investment in the modern economic system, Muslim jurists and economists had been trying to find the Shari’ah alternative. However, to meet the various demands of investors Islamic bonds and certificates had been diversified. Resulting of such effort, the *mudarabah* or *muqaradah* bonds, the *musharakah* bonds, the *Ijarah* bonds, the *istisna’* bonds, the *salam* bonds and the *murabahah* bonds are developed and are significantly appreciated in the global capital markets. However, it is noted that although some of these instruments have been generally accepted as being in compliance with Islamic principles so that they can be traded in the secondary market, the negotiability of some others is still a point of debate and controversy due to their legal acceptability or compliance with Shari’ah. Therefore, some of these bonds can be traded in the secondary market while the trade of others is limited to the primary market because they can be exchanged only at face value.

In Malaysia for instance, almost all of the domestic Islamic debt papers issued, have been based on the principles of *murabahah*, *bay’ bi al-thaman al-ajil*, *bay’ al-’inah* and *bay’ al-dayn*, despite the controversy surrounding the issuance of tradable bonds in the secondary market based on the above four contracts. At the same time, there is a perceptible increase in the willingness amongst Malaysian issuers of bonds to explore other Islamic principles of financing, namely the profit-oriented based *musharakah* as well as the asset-backed mode of *ijarah*. It had been thus anticipated in the late 90s that, the future issuance of Islamic bonds will focus on the widely accepted bonds such as *musharakah* bonds, *mudarabah* bonds and *ijarah* bonds9.

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8 Id

However, the problem with Malaysian Islamic bonds has been the application of bay’ al-'inah and bay’ al-dayn, which is not well accepted by the Middle-eastern investors. The contract of bay’ al-'inah and bay’ al-dayn is seen as something similar to riba based financing. This will certainly pose a great challenge to the Malaysian companies seeking Islamic funds in the Middle-east via bond issues.

Three Main Steps Involved in the Bond Issuance\(^\text{10}\).

- Securitization
- Bond Issuance
- Trading of debt certificates

The Creation of a Tawarruq (special purpose vehicle) Underlying Asset

Asset securitization is the essence of Islamic bond issues, as a bond must assume the role of al-mal or property to qualify as an object of sale. An object of sale in the Islamic law of contract must be a property of value. When a bond certificate is supported by an asset as evidenced via the securitization process, it is transformed into an object of value and therefore qualifies to become an object of trade whereby it can be purchased and sold in both the primary and secondary market. Investors then will have to the right to sell (\textit{haqq mali}) these bonds. In the Tawarruq asset securitization, the financier purchases an asset from the issuer and sells it back to the same party at a credit price through Tawarruq. This buy-back through Tawarruq agreement will ensure that the issuer will receive the money in cash while financier will be paid a prefixed or contracted amount in a future date. Debt payments will be made by installment through bond issues. The difference between cash and mark-up price will represent the profit due to the financier.

\[ \text{Diagram of Tawarruq asset securitization} \]

\(^{10}\) Supra
The underlying asset is therefore crucial in determining the Islamicity of these bonds. In the Malaysian experience these assets include factories, equipment, stock and inventory and even intangible asset such as a list including building and properties.

**Issuance of Islamic Debt Certificate (Shahdah al-Dayn)**

This usually takes place in the primary market where in settling its debt, the issuing company will sell debt certificates or bonds to investors. As mention above, debt certificates issues are valid only when it is supported by an asset. In other words, the bonds must be securitized. Here the underlying security is the *Buy Bi Than Ajil* (sale by deferred payment in long term) or *al-murabahah* (sale by deferred payment in short term) asset. The underlying asset need not be *Buy Bi Than Ajil* or *al-murabahah* alone. If the 1st stage involves a contract of *Ijarah*, then the debt certificate is called *Sukuk al-Ijarah*. If an *Istisna’* (manufacturing) contract is used, we can called it *Sukuk al-istisna’*. Islamic bonds new issues can be categorized into two, namely bonds issues with coupons and those with none. The former is known as the Islamic coupon bond while the latter Islamic zero coupon bond.

**Trading of Debt Certificate – Discounted Bay’ al-Dayn.**

For liquidity purposes, bond trading in the secondary market is crucial. However, almost all Islamic bonds today were bought for long-term investments. The lack of secondary market however should not imply that trading issues is no longer significant. This calls the need to explain the Islamic view of bond trading in the secondary market. As mentioned earlier when a debt certificate is securitized, it now becomes property (*al-mal*) which is also an article of trade. As an article of trade, the bonds can be sold by investors to the issuer or the third party if a secondary market for Islamic bonds exists. The trading or sale and purchase of the debt certificates is called *bay’ al-dayn*. In Malaysia, the contract is *bay’ al dayn* at a discount is acceptable while Middle-east Ulama’ consider it invalid even though the debt is supported by underlying assets. Any profit created from the sale and purchase of a debt is *riba*.

> "And whatever riba you give so that it may increase in the wealth of the people, it does not increase with Allah."  

Prophet Muhammad (saw) ruled out to the effect:

> “That every loan entailing benefit is usury”

**The Nature of Bay’ al-Dayn**

The issue of *bay’ al-dayn* arises when the bonds are traded in the secondary market at a discount. We have to note that buyers in the secondary market are usually speculators, that those who do not intend to keep the bond for long-term investment

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11 al-Qur'an 30:39  
purposes. Their main objective is to make quick capital gains on the basis of market liquidity and interest rate movement. However, there is no indication that controversies exist in the bay’ al-dayn where bonds are sold or redeemed at par value. We may now discuss Bay’ al Dayn to show its nature according to Islamic view.

According to al-Majallah,\textsuperscript{13} Dayn defines as the thing due i.e the amount of money owed by a certain debtor. So also a sum of money not existing is considered a debt, as also a certain sum of money from things which exist or are present, or from a heap of wheat which is present before it is separated from the mass. Al-Dayn can be either monetary, or a commodity, like, food or metal. Based on the aforementioned of al-Dayn, and the literal meaning of Bay’ al-Dayn we can define it as the sale of payable right either to the debtor himself, or to any third party. This type of sale is usually for immediate payment or for deferred payment (al Nasi’ah).

**Sale of al-Dayn (debt) to a Third Party**

According to most of Hanafis, Hanbalis and Shafis jurists\textsuperscript{14}, it is not allowed to sell al Dayn to non-debtor or a third party at all. Such opinions are based on the forbidden sale of al Kali Bil al Kali, sale of a Ghara, sale which the seller does not possess. As an exception Malikis, Hanafis and some Shafi’s jurists allowed selling al-Dayn to a third party. Since the creditor has the right to sell it to the debtor, as well as he has the right to sell it to a third party provided the following rules must be observed:

a. The Dayn must be Mustaqir (confirmed debt) and the contract must be performed on the spot, not deferred in order to avoid any relationship with the sale of a debt for a debt which is prohibited by Islamic law.

b. The debtor must be a financially capable, must accept and recognize the sale, in order that he will not deny the sale. This condition aims to avoid any dispute between the parties, and the debtor must be easily accessible so that the creditor knows whether he has the capacity to pay his debt or not.

c. The sale should not be based on selling gold with silver or opposite, because, any exchanges between these items necessitates the immediate possession, and if the debt is money, its price in another debt should be equal in terms of amount of quantity.

Furthermore, the selling of al-dayn must avoid the occurrence of Riba between the two debts, and must also avoid any kinds of Gharar which may be raised at the level of inability of the buyer from possessing what he bought, as it is not permitted that the buyer sells before actual receipt of the purchased item.

It is important to note that Muslim scholars have unanimously prohibited the trading of debt (bay’ al-dayn) at anything other than face value. Where the price paid for

\textsuperscript{13} Majallah al-Ahkam al - Adliyyah, Art. 158

\textsuperscript{14} Al-Zuhili, Bay’ al Dayn in the Shari’ah, pp. 35/6
a debt is not the same as the face value of that debt, the transaction would be tantamount to *riba al-Nasi’ah* and is therefore prohibited. It is noteworthy that trading in bonds is a subject of dispute on two counts:

First, the bonds are normally sold at less than their nominal values. Second, the state or the issuer would use the mode of *Bay` al-` inah* and *Bay` al-Dayn* and these both sales transactions are regarded as *riba* by the majority of Muslim scholars. This is the very reason for the controversy about the legitimacy of Malaysian Islamic bonds which renders it to be unacceptable by individual Islamic jurists and institutions outside Malaysia and the Middle-Eastern countries. Islam does not allow the legal devices to be treated as a justification for transactions which Islam regards unjust and against Islamic belief. The bonds would have been acceptable from an Islamic point of view if the application of the mode of financing would be based on the legal maxim of *al-Ghunmu bil ghurmi*\(^{15}\) meaning that no person is allowed to invest in a way that generates profit without exposing himself to the risk of loss. It would expose both parties to the outcome of their deal, be it a profit or a loss, and thus avoid of usury as matter of Islamic principle.

**Types of Islamic Bonds (Sukuk)**

**Sukuk al-Ijarah (Lease Bonds)**

*Ijarah* (Lease) is a contract according to which a party purchases and leases out equipment required by the client for a rental fee. The duration of the rental and the fee are agreed in advance and ownership of the asset remains with the lessor. Hence, the relationship between the parties differs from that of a debtor-creditor relationship since it is based on buyer-seller of an asset. *Ijarah* bonds, on the other hand are securities of equal denomination of each issue, representing physical durable assets that are tied to an *ijarah* contract as defined by *Shari`ah*\(^ {16}\).

**Sukuk al-Istisna‘ (Manufacturing Bonds)**

*Istisna‘* (Manufacturing) is a contract to sell a manufacturable good with an undertaking by the seller to present it manufactured from his own material, according to specified description and at a determined price. The suitability of *istisna‘* for financial intermediation is based on the permissibility for the contractor in *istisna‘* to enter into a parallel *istisna‘* contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, and sub contract the actual construction to a specialized firm\(^ {17}\).

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\(^{15}\) Majallah al-Ahkam al -Adliyyah, Art. 158  
Sukuk al-Musharakah (Partnership Bonds)

*Musharakah* bonds based on the *musharakah* contract are relatively similar to *muqaradah* bonds. The only major difference is that the intermediary-party will be a partner of the group of subscribers represented by a body of *musharakah* bondholders in a way similar to a joint stock company while in *mudarabah* the capital is only from one party. It should be noted that almost all the criteria applied to *mudarabah* bonds are also applicable to the circulation of *musharakah* bonds.

**Difference between Musharakah Certificate and a Conventional Bond**

A *Musharakah* certificate represents direct ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. A conventional bond on the other hand, has nothing to do with the actual business undertaken with the borrowed money. The bond stands for a loan repayable to the holder in any case, and mostly with interest.

*Sukuk al-Muqarada* is an alternative to *Sukuk al-Dayn* (Debt Bonds / Debenture Certificates)

The Islamic financial system is a set of rules and regulation that govern the flows of funds from the surplus-spending unit to the deficit-spending unit. These rules and regulations are strictly governed by *Shari'ah* principles where there is neither a possibility nor a need to apply usurious financial instruments such as the debt related bonds. Hence, the solution for Islamic financial system dilemma lies in the development of financial instruments in which the *Shari'ah* rulings are not violated. One such instrument is the *Muqaradah* bond.

A *Muqarada* bond is an Islamic bond in which no interest is earned, but whose market value varies with the anticipated or expected profits. It is the product of Muslim scholars and thinkers who developed and designed the financial instrument where interest or similar forms of returns, which Islam has unequivocally prohibited are excluded. The Council of the Islamic Fiqh Academy of Organization of Islamic Countries (OIC) during its fourth conference in Jeddah, Saudi Arabia from 18 to 23 Jamadul Akhir 1406H/6 to 11 February 1988, approved the mode of *Muqarada* by issuing *Fatwa* after having reviewed various studies on *Muqarada* bonds. The meaning of *Muqarada* bonds and its salient features is given in the following:

*Muqarada* bonds, as the term denotes, are based on the conclusion of lawful “*Muqarada*” (the *mudaraba*) with capital on one hand and labor on the other, and the shares of profit are determined beforehand by a definite proportion of the total. It is called a bond because it is terminal in nature that its maturity is determined by the tenure or project completion date.
Prospects of Sukuk in the Non-Muslim World

By virtue of the announcement on October 29, 2013 by the British Prime Minister that the United Kingdom ought to have been the first country outside the Islamic world to issue sukuk has reaffirmed the increasing interest in this Islamic mode of financing. Over the past decade, Islamic finance has shown a significant growth, with worldwide Islamic financial assets rising from USD 150 billion in the mid-1990s to USD 2.3 trillion by end of 2014. This result is not only in Islamic banking but also by the sustainable development of sukuk. By end of 2012, the value of outstanding sukuk was USD 229.4 billion (with new issues amounting to USD 131.2 billion), representing 14.6% of global Islamic equities. Malaysia accounts for the largest sukuk market with 74% of issues in 2012, but these securities are also usually issued in the GCC.  

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There are two observations: Sukuk structures can either be structured by debt-based or equity-based principles. Debt-based instruments such as *ijara* (lease) and *murabaha* (sale by deferred payment) pay a predetermined rate of return to investors and are thus less eulogized under *Shari’ah* compared to equity-based investments. In contrast, equity-based investments by profit-and-loss sharing principles of *musharaka*, *mudaraba* and *qirad*, which are partnership contracts in which the financier and entrepreneur share profits based on pre-agreed ratios whereas losses are commensurate to their contribution (financial or physical) to the partnership. In light of their *shari’a*-compliance questionability and since these instruments are likely to suffer from the adverse selection mechanism described by Godlewski, Turk-Ariss, and Weill (2013), these sukuk may generate a negative stock market reaction in comparison to debt-based instruments.²⁰

Sukuk structures undergo a strict screening process by religious advisors to ensure their *shari’ah* compliance. These instruments must notably be free from prohibitive elements such as *riba* (interest), *gharar* (uncertainty), *maysir* (gambling), but also from non-permissible activities (e.g. investments in pork, pornographic, entertainment, drugs, and military activities).²¹

**Process and Issuance of Sukuk (Tawreeq).**

Tawreeq for both issuer and investors are as follows. The issuer shall effect:²²

- Liberty from the constraints of the balance sheet which provides financial and accounting rules into account the principle of capital adequacy, and management of provision for doubtful debts that would hamper the activities of finance in general, necessarily slowdown of the capital cycle, and reduces the profitability of banks. Therefore, in the Tawreeq, the situation is allowed to substitute an appropriate a large part of the liberalization of bank funds, which requires her to meet the allotment of such debt.

- Develop the efficiency of the financial cycle, productivity and the rate of rotation through the conversion of non-liquid assets to liquid assets to re-employ them again, thus it would help to expand the size of the facilities without the need to increase the rights of ownership.

- Minimizing credit risk through the distribution of financial risk on a wide range of different sectors.

- A Tawreeq allows credit rating companies with low capital base and low capital access to finance small rates obtained by the segments of the excellent.

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²⁰ Ibid
²¹ Ibid
²² Ahmed Khalid Al-Maghlouth (2009), Sukuk: An inside study of its background, structures, challenges & Cases.OUM, at Pp.31-37
Investors shall effect:23

- Ignoring in risk of the dangers of financial investors, and the recovery of the capital market.
- Analyze some economic sectors of primary markets such as real estate or cars. Moreover, revitalize the capital markets through providing new investment and financing tools, diversify the supply of financial products, and stimulate the circulation of market instruments.
- Its operations help to achieve transparency, improve the structure of the information in the market, and the entry of many institutions in the financing process, which provides more information on the market.
- Impress a variety of segments of the Tawreeq investors, which leads to the expansion of the size of capital markets and the recovery.
- Facilitate foreign exchange to banks and financial institutions creditors in the case of cross-border Tawreeq, since the buyer of the asset in this case is the bank or a foreign financial institution who will pay the local bank the value of the deal by foreign currency, which lead to an increase in domestic bank assets in foreign currency.

Risk factors in Sukuk

Risks faced by the Sukuk industry namely: market risk, credit and counterparty risk, Shari’ah compliance risk, operational risk, and institutional rigidity. Also, it will state the challenges facing the management of financial risks of Sukuk that are challenge of institutional reorganization. In addition, it will talk about the argument said that most of Sukuk implementation are not followed the Shari’ah rules.24

Undesirable risks affect the competitiveness of the pricing of assets. Therefore, the innovation of Sukuks essentially involves a higher exposure to certain market and financial risks. These risks are market risk, credit and counterparty risk, Shariah compliance risk, operational risk, and institutional rigidity. A further illustration is as follows:25

Market Risk

Market risks are of two classes namely: Systematic and Unsystematic. A Systematic risk can arise due to public and economic policies whereas unsystematic risk arises because of different firms' specific instruments are priced out by comparing with other firms’ instruments. Market risk is comprised of profit rate risks, foreign exchange risks, equity price risks and commodity risks. The profit rate risk is rate of return risk

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23 Ibid
25 Ibid
upon which Sukuk is based on fixed rates that are exposed to this risk in the same manner as fixed rate bonds are exposed to the profit rate risk. Moreover, an increase in market profit rates leads to a decrease in the fixed-income Sukuk values. However, all fixed return assets either from Ijarah, Istisna, Salam, Mudharabah, Qiradh or any other origin will face this risk. This also involves reinvestment risk and an opportunity cost of investing at the new rates, particularly if the asset is not liquid as in case of the zero-coupon non-tradable Sukuk.

Credit Risk

It is the probability that a bad-debt or an asset or loan becomes irrecoverable due to a default or delay in settlements while the counterparty risk is the probability that the counterparty retracts on the conditions of the contract if the relationship involves a contractual arrangement. The consequences can be severe with a decline in the value of a bank’s assets. The credit and counterparty risks inbuilt in Islamic finance are unique owing to the nature of Islamic financial instruments that become the foundation of the Sukuk asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms due to Shariah considerations.

Risk as to Shari‘ah Compliant

The risk as to Shari‘ah compliant is the loss of asset value as a result of the issuers’ breach of its fiduciary responsibilities with respect to compliance with Shariah. For example, if the Sukuk is based on a hybrid of Ijarah and Istisna assets, Ijarah must always be more than Istisna’ in the pool, otherwise the Sukuk deed will dissolve. Thus broadly speaking, Shariah compliance risk must be defined as a rate of return foregone in comparison to the market rates, as a result of complying with the Shari‘ah. Moreover, fixed rate Sukuk faces serious market risks. So, to match the market requirements of Sukuk to be floating rate, and the Shari‘ah requirements of rents to be fixed rate, the Ijarah Sukuk are based on a Master Ijarah Agreement with several subordinate Ijarah agreements. However, the investors could still face profit rate risk to a certain extent and since the originator can only guarantee the fixed return on the underlying asset pools, the issue of floating rate returns still remains contentious, particularly, in pooled or hybrid Sukuk. Therefore, the association of Shariah supervisors with Sukuk issues will ensure investor confidence.

Management and Operational Risk

The management and operational risk, which inherent to the structure of the issuances rather than the underlying Shari‘ah principles. The risks related specific to the operation are mirror to those existent in conventional bond markets are Default Risk, Coupon Payment Risk, Asset Redemption Risk, Investor Specific Risks, and Risks Related to the Asset. Default Risk is when each party has provisions for the termination

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26 Ibid
27 Ibid
28 Ibid
of the certificate in the event of a default by the obligor. Coupon Payment Risk is when the obligor may fail to pay the required coupons on time. Asset Redemption Risk is when the originator has to buy back the underlying assets from the certificate holder. Investor Specific Risks is when the certificate holder is rendered to several risks relevant to Sukuk structures such as liquidity management issues in Islamic finance. Risks Related to the Asset is when the underlying assets of the Sukuk certificates are subject to numerous risks such that the risk of loss of the assets.29

Organizational Rigidity Risk

The banking and financial infrastructure is weak in most emerging economies’ countries despite a significant move had been observed in some of these countries such as Bahrain, Saudi Arabia, Malaysia and Brunei, Indonesia are among others. However, Sukuk require unique Shari’ah compliant structures which create a state that can be termed as one of institutional rigidity and that cannot be removed in the short run and always increasing the risks of Sukuk. Furthermore, the features of this state are lack of hedging and financial engineering processes, nonexistence of inter-bank money markets, lack of best practice uniform regulatory standards and regimes, weaknesses in litigation and legal framework support, particularly, in the treatment of default, non-uniform accounting, auditing and income and loss recognition systems, non-robust investment appraisal, promotion and monitoring infrastructure, ineffective external credit assessment systems, rudimentary state of financial markets, and weak inter-segmental support and linkages.30

Managing the Sukuk Risks

Sukuk serves to replicate the functions of conventional bonds and tradable securities in resources mobilization from markets and injecting liquidity into the enterprise or government and in providing stable resource of income for investors. Moreover, investing in Sukuk issuances involves the funding of trade or production of tangible assets. So, this section will state the challenges facing the management of financial risks of Sukuk that are the challenge of institutional reorganization.31

Organizational Challenges

Government Debt Management upon which the fixed income markets in developing countries is dominated by government bonds. Therefore, the single most important reorganization of the markets can come from the reorganization of the public debt management. The introduction of derivative markets has further consequences on market and financing dynamics. Furthermore, markets stabilizing role of futures and options markets depends on the speculator’s information Futures and options markets can also serve to stabilize the value of underlying assets by acting in an insuring role and this can occur if these markets allow investors to pool risks more efficiently and share them. Therefore in short, the evolutionary changes of financial innovation, deregulation,

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29 Ibid
30 Ibid
31 Ibid
globalization of financial services and introduction of novel financing instruments warrants the adoption of supporting risk management mechanisms, viable secondary markets and relevant regulatory bodies.\textsuperscript{32}

The emergence of the market for asset backed securities over the past two decades has permitted banks around the world to free their capital by re-packaging and reselling portfolios of loans, assets and other receivables. This adjusts the criteria for lending by forcing financial institutions to meet the market’s standards for loan quality and sufficient pricing for risk. It helps decrease funding risk by diversifying funding sources. Financial institutions also employ securitization to purge profit rate mismatches. Also, it creates more complete markets by introducing formerly remote asset classes that better suit investor risk preferences and by increasing the potential for investors to achieve the benefits of diversification. Therefore, by meeting the needs of different market segments, securitization transactions can generate gains for both originators and investors. The same benefits can be attributed to Sukuk certificates. They allow the institution to manage balance sheet mismatches to securitize longer term assets. Moreover, investors are also given the option to invest in asset grades that are suitable for their investment needs. Also, financial markets are more complete as previously and untapped assets are now available for public sector resource mobilization.

The Liquidity and secondary markets, portray varying risk preferences and a secondary market should be developed to reflect this. Sukuk certificates are unique in that the investor becomes an asset holder and is directly tied in to the nature and functioning of the underlying asset pools so Sukuk certificate holders carry the burden of these unique risks. The primary concern of an Islamic secondary market is its marketability.\textsuperscript{33} All things being equal, a certificate holder would rather participate in a well-structured and well regulated secondary market instead of trading in a poorly run market. However, the challenges remain to provide increased risk management mechanisms, increase market liquidity, create a truer bond yield benchmark as well as expanding the issuer and investor platform.

It is has been observed that, the unfavorable risks facing the Sukuk industry such as market risk, credit and counterparty risk, Shari'ah compliance risk, operational risk, and institutional rigidity that affect the competitiveness of the pricing of assets which lead to fact that is the innovation of Sukuks essentially involves a higher exposure to certain market and financial risks. However, I believe that we should take care most on unsystematic market risk and Shari'ah compliance risk in certain manner because they are related to each other in sense of that market risk will increase if the Shari'ah compliance risks increase.\textsuperscript{34} Furthermore, the current Sukuk margin / profit based on LIBOR as indcitor only but still we depend on it which leads us to violate the Shari'ah compliance that will cause the market risk increase because most of Sukuk holder/investors are Muslims who search for Shari'ah compliant products to invest and avoid investing in non-compliant product or questionable products, and in our case it could be questionable product unless we try avoid this risk.

\textsuperscript{32} Ibid
\textsuperscript{33} Ibid
\textsuperscript{34} Ibid
This can be through set fixed percentages not related to anything even if as indicators. It is true that the Sukuk issuers in some periods will face problems on their projects due to crises of economy or complexities on their project but they should do and sacrifice in order to avoid violating in Shari‘ah compliances. Moreover, in order to develop the market of Sukuk an avoid the risks of Shari‘ah compliance, capital authorities of all Muslims countries should establish and create Sukuk Authority Institution that report to organization of Islamic conference (OIC), and unified the rules and regulations of Sukuk issuing; price of Sukuk is among others.

**Sukuk and its Rating Formula**

*Credit rating*

Securities Commission (SC) rules out as to the effect of credit rating in Sukuk that;  

- All issues, offers or invitations to subscribe or purchase sukuk must be rated by a credit rating agency.
- The final rating for the sukuk must be made available to the SC at the time when the submission for approval to issue, offer or make an invitation to subscribe or purchase sukuk is made to the SC.
- Where the final rating is not available, an indicative rating must be submitted to the SC.
- In the case of a sukuk program where the rating is not assigned for the full amount but for part of the amount (partial rating):
  (a) the first issue under the sukuk program must be rated; and
  (b) the principal terms and conditions of the sukuk program must include:
     (i) a disclosure of all the pre-conditions, relevant risk factors and all material information relating to the partial rating; and
     (ii) a provision that states all subsequent issues of the sukuk program will be rated.

*Appointment of credit rating agency*

The Guidelines Further provides that;  

- Sukuk rated on a local rating scale must be rated by a credit rating agency registered with the SC.
- Sukuk rated on an international or regional rating scale must be rated by an international credit rating agency.

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37 Ibid
An issuer incorporated in Malaysia may appoint an international credit rating agency to assign a rating for its ringgit-denominated sukuk, provided that:

(a) the issuer had previously issued a foreign currency-denominated sukuk for which an international or regional rating has been assigned;

(b) the issuer is appointing the same international credit rating agency; and

(c) any existing international or regional rating of the issuer’s sukuk by that international credit rating agency is still valid on the date of submission to the SC.

Issuer’s obligations

The Guidelines Provides to the effect: 38

• An issuer must provide relevant information on a continuous and timely basis to the credit rating agency. This is to ensure that the credit rating agency can continuously make available to investors the rating for the sukuk.

• An issuer must ensure that the rating report is published by the credit rating agency as soon as the rating has been finalised, or at least seven business days prior to the issuance of the sukuk.

• The issuer of the sukuk must not replace the appointed credit rating agency during the tenure of the sukuk unless investors’ consent has been obtained.

Non-application of requirements

The Guideline further rules out to the effect: 39

• This chapter (9 of the guideline) does not apply to an issue, offer or invitation to subscribe or purchase the following types of sukuk:

(a) irredeemable convertible Islamic loan stocks;

(b) foreign currency-denominated sukuk;

(c) convertible sukuk or Islamic loan stocks and exchangeable sukuk which fulfill the following requirements:

(i) investors of the sukuk or Islamic loan stocks are given the right to convert or exchange the instruments into the underlying shares at any

38 Ibid
39 Ibid
time or within a reasonable period or periods during the tenure of the sukuk issue; and

(ii) the underlying shares are listed on a stock exchange;

(d) Sukuk:

(i) which are non-transferable and non-tradable; and

(ii) whose investors do not require a rating.

• The principal adviser must ensure that both criteria are met prior to the issue, offer or invitation to subscribe or purchase the sukuk and confirm this in writing to the SC.

Conclusion

As has been scrutinized that, the conventional bond market comprises of primary market and secondary market. The primary bond market is where the bonds are initially issued, while the secondary market where the bonds are resold to other investors. Islamic bonds (Sukuk) conceptually share the similar phenomena as the conventional model, but not in mechanism, technicality, rules and standard of operation or practicality thus, are also having primary and secondary markets. The main difference, however, is the way the bonds are issued and traded afterwards. In the process of Islamic bond issuance Tawarruq is used to securitize the instrument in the primary market, while in the secondary market, bay’ al-Dain is used in order to legalize reselling of the bonds. Such process is mostly used in the Malaysian market, while most of the Middle-Eastern countries do not accept it. The proposed alternative is Islamic bonds based on Muqaradah.

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Islamic Banking and Finance in North Africa: An Extensive Review

By

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Abstract

The objective of this study is to highlight the current industry and research state of Islamic finance in North Africa, a region that has been late in applying Islamic finance. The study focuses on document analysis, in the form of library research (literature review). The reviewed literature revealed that a considerable amount of studies on Islamic finance have been conducted in the North African setting. However, majority of these studies were conducted in the Tunisian context compared to the remaining countries. Furthermore, there seems to be no real connectivity and continuity among these studies.

Keywords: North Africa, Islamic Finance, Banking, Review

JEL Classification Code: G15, G21, G23

Introduction

Recently, great interest has been paid to Islamic banking and finance worldwide particularly after the international subprime crisis which had no impact on Islamic banks (Ftiti, Nafti and Sreiri, 2013). In fact, Islamic banking has continued to grow strongly between 2010 and 2014 with a compounded annual growth rate (CAGR) of more than 16% (World Islamic Banking Competitiveness Report 2016). According to the

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mentioned report, Islamic banking profit pool is estimated at US$10.8b in 2014 and is expected to reach US$30.3b by 2020. This important growth and profit are due mostly to nine leading countries - the Gulf Cooperation Council (GCC) countries, Malaysia, Turkey, Indonesia and Pakistan - which account for more than 93% of industry assets (World Islamic Banking Competitiveness Report 2016).

Moreover, non-GCC countries in the MENA region have recently made enormous efforts to establish new Islamic banks and to develop specific laws to regulate Islamic banks activities. Consequently, the number of Islamic banks is increasing in non-GCC countries (Almarzoqi, Ben Naceur and Scopelliti, 2015).

However, except the study published by the African Development Bank in 2011, no other work has been focused on Islamic banking and finance in North Africa. After six years, it is worth refocusing on these countries to see their achievements and potential growth in the field of Islamic banking.

In this paper, we cast a glance on the recent developments and highlight the efforts of North Africa countries (Algeria, Egypt, Libya, Morocco, Sudan and Tunisia) to create and enhance a favorable environment for Islamic banking and finance. This study contributes to the existing literature in two ways: it focuses on the Islamic banking environment in North Africa and it prepares background for future empirical researches in these countries.

The remainder of this paper is structured as follows: each section provides a review of the current status of Islamic banking and finance in one of the above-mentioned countries. The last section concludes the paper and provides some recommendations for future studies.

**Morocco**

In the context of Morocco, Islamic banking has gone through a long process of negotiations and debates before being officially approved by the central government on January 2nd, 2017. Specifically, five banks were authorized to launch Islamic banking products, namely, Attijariwafa, Banque Populaire, BMCE Bank, CIH Bank and Crédit Agricole du Maroc. The Moroccan Central Bank has also given approval for three subsidiaries of French banks, namely, Société Générale, BNP Paribas and Crédit Agricole.

Just like other countries, the term participatory banking is employed rather than the commonly used term, i.e. Islamic banking. This is usually done in order to allow these banks to operate away from the religious debate.
In the Moroccan context, few studies only were conducted on Islamic banking and finance. One of these studies is by Soudi and Cherkaoui (2015) that explored the possible obstacles and issues that might face Islamic finance implementation in Morocco. The study found that the commercialization of Islamic banking services earlier in 2007 failed essentially due to the presence of several constraints that faced their competitiveness compared to their conventional counterparts. The first constraint was the over-taxation that penalized the prices of Islamic banking services and the high cost of fees and commissions that were applied by the Moroccan banks. The second constraint is the discrimination of the political communication since the target audience could not perceive the specific characteristics of Islamic financial services. The final constraint was the low involvement of socio-economic operators who did not want to invest in such new services. Nevertheless, there is still a huge potential for Islamic finance in Morocco.

In a different study, Abdel Aziz, Echchabi, Ayedh, Azouzi, Musse, and Houssem Eddine (2015) reviewed the state of Islamic banking in Morocco and attempted to identify the factors that influence the adoption of Islamic banking services in the country. The findings revealed that the main factors that influence the decision of the Moroccan customers to adopt Islamic banking services are relative advantage, compatibility and social influence. Furthermore, the findings revealed that the progress of Islamic banking in Morocco is faced by multiple legal and regulatory challenges.

**Algeria**

“Currently six state-run banks plan to start Islamic financial services by the end of 2017 or early 2018, and a national Shariah board that would oversee Islamic banking is also planned by the end of 2017. Algeria's Islamic finance plan still faces huge barriers. It lacks a legal framework and technical expertise, and officials must navigate sensitivities over any perceived revival of political Islam after the 1990s war. On top of such concerns, any kind of reform is often delayed in Algeria by heavy bureaucracy and inertia, but bankers are keen to push ahead with the idea”.

In the Algerian context, Benamraoui (2008) conducted a detailed analysis of the Islamic banking in Algeria following the financial liberalization initiated in the 1990’s. The study also examined the performance of the sole bank offering Islamic financial products in Algeria by the time, namely, Al Baraka Bank of Algeria. Furthermore, the study aimed to analyze the methods adopted by the bank to improve the allocation of its financial resources and to improve its earnings. The study used a mixed method approach in form of in-depth interview, as well as quantitative analysis in the form of ratio and regression analyses. The findings showed that Al Baraka Bank of Algeria offers only few Islamic financial products to its customers, which are mostly geared towards short-term financing. In addition, the bank’s overall performance has improved since its operations in Algeria. Finally, it is noteworthy that credit risk was the main obstacle facing the bank.

Elhachemi (2012) explored the obstacles that hamper the success of Islamic banking and finance in Algeria. There is a positive effect and significant relationships

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http://www.reuters.com/article/algeria-economy-islamicfunds-idUSL8N1HJ1YQ
Accessed on May 27th, 2017
between the technical and social obstacles and the adoption of Islamic Banking in Algeria. Whereas, the legal obstacle has a negative correlation within the adoption of Islamic Banking in Algeria. These variables are significantly and highly correlated with the adoption of Islamic Banking initiatives. These results proved that there are many social, legal and technical obstacles which hamper the success of Islamic banking and finance in Algeria.

Azouzi and Lataifa (2013) ran a comparative study between a number of Islamic banks in countries where Islamic banking and finance is well developed and in others where this industry is still at a rudimentary stage. The study was focused on a period of five years from 2005 to 2009 and employed financial ratios and window analysis. The findings revealed that the global performance of the Algerian Islamic bank (Al Baraka Bank, Algeria) is increasing despite its global inefficiency throughout the period examined.

Nourdin and Fares (2016) were interested in exploring the issues and challenges that can face the introduction of takaful into the Algerian financial market. An empirical study based on semi-structured interviews with Algerian experts in the area of Islamic finance and takaful was undertaken. This study revealed that economic and spiritual benefits would be generated if takaful is introduced in Algeria. The findings showed also that a political support as well as an important publicity, an amendment of the laws and the development of some infrastructures are considered as compulsory steps in order to make of the introduction of Islamic insurance in Algeria a great success.

Tunisia

There are currently three active Islamic banks in Tunisia, the oldest of which is Zitouna bank, which was first established back in 2010. This was followed by Al Baraka Bank which was transformed from a non-resident bank to an on-shore bank in January 2014. Relatively new is Wifack International Bank which was transformed from a leasing company to an on-shore bank and which was granted a banking license in November 2015 and authorized to transform its activity to Islamic banking. More importantly, actually (May 2017), Tunisia is currently paving the way, with the collaboration of Nasdaq Dubai, for Tunisia’s first issuance of a sukuk.

In this context, Chebab and Zribi (2012) investigated the major determinants of banks’ selection by customers when shifting from conventional to Islamic banks in Tunisia. The results showed that the most important variables influencing customers’ choice are quality of the relation between customer and bank, diversity and quality of products and the image of the bank.

Azouzi and Lataifa (2013), in their above-mentioned study aiming to compare Islamic banks in the Arab Maghreb Union and in other countries like Kuwait, Saudi Arabia, Malaysia, etc. found that the global performance of the Tunisian Islamic bank is increasing and it tends to efficiency.

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Taktak and Zouari (2014) studied the extent of Islamic finance implementation in Tunisia. The findings revealed that there is a need to establish a specific regulatory framework, supervisory standards and rules of accounting for institutions offering Islamic financial services. The study also recommends the development of Islamic financial education to strengthen the role played by the Islamic financing Ecosystem and to help Tunisia promote local and exportable expertise to other countries. Finally, the findings recommend authorities to focus more on promoting market for Sukuk, Takaful and microcredit to fund small and medium enterprises.

Slimen, Makni and Ben Rejeb (2014) examined the customers’ satisfaction about the compliance of the banking services with the Shari’ah rules in Tunisia, focusing on Zitouna Bank. Meanwhile, the study has also explored the main Islamic banks’ selection criteria. The findings revealed that the customers are generally satisfied with Zitouna Bank and its compliance with the Shari’ah rules. Furthermore, the findings showed that the religious factor is not the primary motivation for the customers to select the bank they patronize but rather the economic and financial benefit.

Ben Jedidia Khoutem (2014) examined the opportunities of Islamic finance/Sukuk in promoting economic growth in Tunisia after the 2011 revolution. The findings revealed that the marketable Islamic intermediation provides easily more funds to finance the economic development and solve the problems of poverty and unemployment. It also revealed that Islamic intermediation can be improved by a more important implication of banks in the Sukuk markets. This permits to overcome many problems related to saving mobilization, bank liquidity management, risk taking and long-run investment.

According to the Annual Report on Banking Supervision 2015\textsuperscript{6}, Islamic banking products have recorded an annual average growth of 23 per cent during the period 2010-2015. This is proof in favor of the significant growth potential of Islamic products in Tunisia.

Besides, a specific law (n° 2016-48)\textsuperscript{7} regulating Islamic banking operations in Tunisia was promulgated in July 2016. This legislative text aims to define Islamic banking activity in Tunisia and to explain Murabaha, Istimana’, Ijarah, Salam, Mudharahe and Wakalah contracts. These efforts to facilitate the introduction of Islamic banks in the Tunisian banking sector are valuable. However, Islamic banking products account actually for only five per cent of banking assets in Tunisia (the Annual Report on Banking Supervision 2015).

Echchabi, Azouzi and Abdel Aziz (2016) investigated the extent of readiness of the Tunisian customers to adopt Islamic banking services and the factors that might influence their decision, using structural equation modeling. Their findings showed that the attitude dimensions have a significant impact on the Tunisian customers’ intention to adopt

\begin{itemize}
\item \textsuperscript{7} \url{https://ribh.files.wordpress.com/2016/08/loi-2016-48.pdf}, accessed on May 10\textsuperscript{th}, 2017.
\end{itemize}
Islamic banking services. On the other hand, the results have also shown that the Tunisian customers are willing to shift to Islamic banking services.

Obeid and Kaabachi (2016) attempted to identify the main factors influencing the adoption of Islamic banking in Tunisia. Based on a primary data collected by self-administered questionnaires involving a sample of 239 respondents located in Tunis City, the results demonstrated that religious commitment, the amount of information held by consumers about Islamic finance, the relative advantage of Islamic banking and its compatibility with consumer values, lifestyle, and banking habits are the main predictors of its adoption. The findings also reveal that there is a general lack of information about Islamic banking among Tunisian consumers.

Libya

Libya is planning to transform its banking and economic system to comply fully with Islamic law that bans interest payments. Under Muammar Gaddafi, who was overthrown in 2011, the growth of Islamic banking was not encouraged and four state-controlled institutions dominated the relatively undeveloped financial sector of the OPEC oil producer. Six years after Gaddafi's ouster, the current regime is focusing on attracting foreign investment and developing the non-oil sector of the economy but is struggling to assert its authority against heavily-armed tribesmen and militias and parts of the country remain outside its control. It has also been weakened by political wrangling with Islamists who dominate the parliament, the General National Congress (GNC), which strongly backs the plans to introduce Islamic law into the economy.8

In this regards, Gait and Worthington (2009) examined the attitudes, perceptions and motivations of Libyan retail customers toward Islamic finance methods, focusing on a sample of 385 respondents between December 2007 and February 2008. The results indicate that most of the respondents have an acceptable level of knowledge about some aspects of Islamic finance, including Musharakah (full-equity business partnerships) and Quard Hassan (interest-free benevolent loans). However, they are generally unaware of many other related products. Nonetheless, most of the respondents are potential users of Islamic methods of finance at the retail level, though potential use varies remarkably according to age, level of education, employment, income and nationality. Specifically, discriminant analysis shows that religion and community service are the most important factors determining the potential use of Islamic methods of finance by retail consumers in Libya.

Gait and Worthington (2009) investigated the attitude of the Libyan business firms towards Islamic methods of finance focusing on a sample of 296 Libyan firms. The authors applied simple descriptive analysis tools and found that most of the firms are aware of the existence of Islamic banking and finance, while more than two-thirds of respondents know the specific products of Musharakah (full-equity partnerships) and Quard Hassan (interest-free benevolent loans), often through personal informal lending. However, many respondents are uninformed about other Islamic financing methods.

8 http://www.reuters.com/article/us-libya-islamic-banks-idUSBREA050PX20140106
Accessed on May 27th, 2017
Furthermore, discriminant analysis showed that religion remains the primary motivation for the potential use of Islamic finance among business firms in Libya.

Stela and Bardai (2013) explored the perception of the Libyan customers regarding the existing banking system, and the potential implementation and introduction of effective Islamic banking system in the country. The authors focused mainly on Tripoli, the capital city as it is considered the commercial center in the country. Their findings revealed that the Libyan customers are not satisfied with the existing conventional banks due to their dealings with usury. They rather prefer implementing Islamic banking tools in the entire country.

Khafafa and Shafii (2013) examined the level of customers’ satisfaction regarding the Libyan banks that mostly operate Islamic banking windows, rather than full-fledged Islamic banks. Furthermore, the study investigates the level of customers’ awareness about the major Islamic banking concepts such as mudharabah, musharakah, murabahah, ijarah. The findings revealed that there is a significant positive relationship between customer satisfaction and constructs of service quality model such as tangibility, responsiveness, assurance and empathy, with the exception of the reliability dimension which does not have any effect on customer satisfaction. Moreover, the findings indicated a high level of general principles of Islamic finance. Nevertheless, the customers were mostly unaware about concepts like mudharabah and musharakah.

Abdesamed (2014) attempted to assess the tendency of the Libyan SMEs to use the Islamic modes of financing. The educational background of the firm’s owner, the firm’s size, collaterals, and loans with interest were found to be negatively related to application of the firm for a bank loan. However, the firm’s business plans and its start-up with bank loan were found to be positively related to the firm’s application for bank loans. Yet, business plans, experience, and educational background were insignificant to the firm’s access to bank loans. The firm’s age, size, and start-up with bank loan were negatively related to its difficulties in securing a loan. It is found the tendency to use Islamic bank varies between those firms which consider formal financing with the ones relying on informal financing with the latter tends more to use Islamic bank. This study can serve academic researchers, policy makers, and developing countries as a model of SMEs’ accessibility to external formal finance (i.e., conventional and Islamic finance).

Stela and Abdulsalam (2016) investigated the customers’ satisfaction of the Islamic banking services in Libya. The authors focused on a sample of 500 respondents. The findings revealed that most of the respondents believe that the state government has to play a more important role in redirecting and readjusting the Islamic banking industry. Furthermore, majority of the respondents believe that the quality of the Islamic banking services can be improved by attracting foreign sponsors in the Libyan market.

Egypt

“Despite the absence of an Islamic banking framework, Shariah banking products are made available by fully-fledged Islamic banks (Al Baraka Bank Egypt, Faisal Islamic Bank, Abu Dhabi Islamic Bank Egypt) and Islamic windows of conventional banks such as NBK-Egypt and Ahli United Bank. In fact, the country was among the first in the
region to offer Islamic micro-financing products. United Bank is also reportedly seeking to convert its operations to become a fully-fledged Islamic bank. Despite the devaluation of the Egyptian pound and tough macroeconomic conditions, Islamic banks in Egypt have performed well in 2016 with each bank reporting double-digit profits appreciation and expansion in branch network”.

In this context, Mouawad (2009) analyzed the status of Islamic finance in Egypt in the complex political-economic context of the country. The findings revealed that the share of Islamic finance in the Egyptian economy is modest at local, regional and global levels. This backward position could be justified by the government policies and their manipulation over the legal, economic and religious institutions in a way that restrain the performance of Islamic financial institutions. However, the responsibility is not solely the government's, Islamic financial institutions bear part of such retreat due to their practices that divert them from their main mission.

El-Gawady (2012) mentioned that the experience of Islamic banking in Egypt is still difficult and a deep gap was detected between Islamic banking theoretical framework and its practice. This difficulty is due, according to this study, to a lack of qualified management.


Abdel Megeid (2013) explored the potential impact of banks’ service quality on customers’ satisfaction and banks’ financial performance, and their possible impact on the corporate social responsibility (CSR) implementation in the Egyptian conventional banks versus Islamic banks. The study found that there is a positive relationship between the profitability and operation levels and liquidity performance, at both conventional and Islamic banks. Moreover, the results revealed that conventional banking has better financial position than Islamic banking.

Youssef and Samir (2015) performed a comparative analysis on the financial performance of Islamic and conventional banks. The findings of the research provided evidence that some of the inter-bank factors have significant effect on the financial performance of these banks. However, no considerable differences between the Islamic and conventional banks were found, which suggests that bank type is not a significant variable and that conventional and Islamic banks do not differ from each other with respect to the variables under investigation.

Sudan

“Sudan has maintained a growing base, while depending solely on Shariah-compliant transactions since 2002. Multiple market players including banks, insurance companies and microfinance institutions are expanding, under the governance of the Central Bank of Sudan. Banking assets reached SDG 92 billion (US$ 15.6 billion), showing a growth of 16.64% between 2009 and 2014. Total contributions by Sudan’s insurers reached SDG 1.1 billion (US$ 180.1 million) in 2013. Sudan also, dominates the global sovereign short-term Sukuk market after Malaysia. The total assets of operating banks in Sudan have increased by 19% from 2013 to 2014, but Sudan still remains under-banked with financial institutions concentrated predominantly in and around the capital, Khartoum.”

In this regards, Saaid, Rosly, Ibrahim, and Abdullah (2003) investigated the X-efficiency (technical and allocative) of the Sudanese Islamic banks, using basic Stochastic Frontier Approach (SFA) between 1989 and 1998. The findings revealed that banks in the sample had low levels of X-efficiency, which implies that the Sudanese Islamic banks were not optimizing their inputs usage. However, the results also showed that the inefficiency in the Sudanese Islamic banks could be more associated with technical inefficiency rather than allocative inefficiency.

Mohsin (2005) is one of the early studies on Islamic finance and its practice in Sudan in an attempt to discover how successful the implementation of Islamic finance in the country was. The analysis revealed that conducting trade and business activities on the basis of lawful and permissible profits encouraged more savers to deposit their money in Islamic banks. This has consequently motivated the Sudanese government to convert all the existing conventional banks into interest-free banks since the beginning of 1990s. This decision has further encouraged more Islamic banks to start operations in all regions of the country. This process resulted in increasing the amount deposited by savers and hence the financing and promotion of the agricultural, industrial and social sectors.

Babiker, Awad, Mohamed and Ebrahim (2011) evaluated the Islamic banks in Sudan during the period from 2006 to 2009 and focused the performance analysis on three Islamic banks: the Faisal Islamic Bank Sudan (FIBS), the Sudanese French Bank and Al Baraka Bank Sudan. The evaluation pointed out the success of these three Islamic banks and their significant growth during this period despite the international crisis that characterized it. This study highlighted also that in Sudan, the main forms offered by Islamic banks are Murabahah, Musharakah, Mudarabah and Ijarah with an intensive use of Murabahah. This success is due to the right decision taken by the government of Sudan to change the banking system into an Islamic one. However, the authors asked the government to construct a high independent committee of Islamic regulation whose mission consists in evaluating and monitoring the performance of Islamic banks in Sudan.

Using Data Envelopment Analysis (DEA), Onour and Abdalla (2011) studied the efficiency performance of 12 Sudanese banks during the period 2007-2008 and found that only the two largest banks performed scale and pure technical efficiency scores and concluded that the bank’s size is an important factor for scale efficiency in Islamic banks.

Discussions and conclusions

The main objective of the study was to examine the current status of Islamic banking and finance in North Africa i.e. Algeria, Egypt, Libya, Morocco, Sudan and Tunisia. The overall findings are promising since there is significant evidence that the studied countries are making great continuous efforts toward the establishment of Islamic banks by elaborating suitable laws, explaining and informing citizens about new Islamic products and services and facilitating the procedures for new Islamic banks installation. It is then expected that these countries would gain a significant global market share side by side with leading Islamic finance countries.

It is recommended that the future studies conduct empirical research to uncover the contribution of Islamic finance to the economic development of the North African countries. Furthermore, future studies are recommended to be multi-dimensional in nature, covering the economic, political, finance, marketing aspects, etc.

References


The Impact of Selected Macroeconomic and Bank Specific Determinants on Islamic Deposits in Malaysia

By
Abdullah Ludeen

Abstract

Conventional theories have identified several factors which motivated the savers to save in conventional banks, but conceptually Islamic banks are different from their conventional counterparts. This study makes an attempt to empirically investigate whether the determinants of deposit in Islamic banks are significantly different from its conventional counterpart or otherwise. The ARDL approach ECM model are applied to address this issue, time series data from Malaysian banking system is used for analysis. According to our knowledge, this is the initial attempt to address this issue by testing both macro-economic and bank-specific factors in this particular time period (2007-2015). The results indicated that among the macro-economic variables; Industrial production index (GDP Growth) has strong impact on Islamic banking deposits while inflation (CPI) does not have significant impact on Islamic deposits. Furthermore, among the bank-specific variables both interest rate and profit rate have strong impact on Islamic deposits. However, the most relevant finding from policy perspective is that depositors of Islamic banks in Malaysia are profit oriented, thus an increase or decrease in profit given to deposits will change their intention towards depositing in Islamic banks. Furthermore, since the customers of Islamic banks in Malaysia are divided into the categories of Muslim and non-Muslim, thus, any changes in conventional interest rate will affect the level of deposits in Islamic banks. The implication of this study suggest that Islamic banks must invest in profitable projects and provide high profit rates to their depositors, which will help them keep their depositors for long time.

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Keywords: Determinants, Deposits, Islamic banks, Malaysian banking

1. Introduction

Interest is the main determinant (incentive) for conventional banks to attract deposits, such as they charge borrowers at high rate and pay to their depositors at a lower rate and from the margin conventional banks generate profit. Hence, interest rate has always been featured as one of the important considerations in explaining the saving behavior of individuals. Such as, according to Classical economic theories, saving is a function of the interest rate. The higher the rate of interest, the more money will be saved, and people will be more willing to forgo present consumption.

Based on utility maximization model the consumers are assumed to be rational, trying to get the most value of their money. Given the present value of consumers’ lifetime resources, the rate of interest provided to deposits will play a fundamental role of consumer behavior towards saving. For a net saver an increase in the rate of interest will have an overall effect composed of two partial effects: an income effect leading to an increase in current consumption and a substitution effect leading to a reduction in current consumption (Aleskerov et. al, 2007).

The importance of interest in conventional economy is evident from several theories of conventional economics. Such as, Keynes (1936) argues that despite the quantitative importance of the interest rate, the long run substantial changes in the rate of interest could modify social habits considerably, including the subjective propensity to save.

However, according the religion of Islam the interest and interest bearing activities are strictly prohibited (Haram) and those who are dealing in interest are fighting with Allah(SWT) (Al-Quran, 2: 275). Hence, Muslims must strictly follow the theory of Halal and Haram in any circumstances. Therefore, according to the doctrine of Islam; the Muslim should avoid interest bearing activities and invest their funds in Halal activities.

Theoretically there is controversy in the determinants of deposits and functions of deposits, such as the theories of saving in conventional and Islamic banking are conflicting and there is no clear indication of whether the determinants of saving in conventional banks result in the same consequences for Islamic banks or otherwise, thus theoretically this controversy remains unsolved.

However, there are numerous empirical studies that have addressed the determinants of saving in Islamic and conventional banks, according to Etem and Bengul (2014), Islamic banks are sensitive to the conventional banks’ interest rates in Turkey. In the same manner, Haron and Ahamd (2000) confirmed that customers who place their deposits at Islamic saving and investment account facilities are guided by the profit motive in Malaysia.

Kasim et al (2009) analyzed the impact of monetary policy shocks on the conventional and Islamic banks in a dual banking system. The study further determines
the sensitivity of the Islamic banks by analyzing the impact of interest rate changes on the bank’s financing and deposits. The result indicates that the monetary policy is more destabilizing on the Islamic banks than the conventional banks and the response of the Islamic deposit was significant and negative to interest rate changes.

However, neither theories nor the empirical studies are in conformity which each other and several researchers have reported conflicting results. The empirical disagreements might be because of different data or country specific factors. Thus the issue still remains unsolved which needs further investigation. Therefore, this present research will address the issue specifically from macroeconomic and bank-specific factors in Malaysia.

2. Theoretical Background

Theoretically there are several factors which attract savings and change the behavior of consumers towards consumption and saving. Such as, according to Classical economic theories, saving is a function of the interest rate. The higher the rate of interest, the more money will be saved, since at higher interest rates people will be more willing to forgo present consumption. Hence, the interest is the main determinant (incentive) in conventional banks, such as they charge borrowers at high rate and pay to their depositors at a lower rate and from the margin conventional banks generate profit. Therefore, interest rate has always been featured as one of the important considerations in explaining the saving behavior of individuals.

Based on utility maximization model, the rate of interest is also at the center of modern theories of consumer behavior. Given the present value of lifetime resources, for a net saver an increase in the rate of interest will have an overall effect composed of two partial effects: an income effect leading to an increase in current consumption and a substitution effect leading to a reduction in current consumption (Aleskerov et. al, 2007).

The importance of the interest in conventional economy is evident from several theories of conventional economics. Such as, Keynes (1936) argues that despite the quantitative importance of the interest rate effect believes that in the long run substantial changes in the rate of interest could modify social habits considerably, including the subjective propensity to save.

In addition, from the depositors perspective there are main theories related to saving behavior; such as the permanent-income hypothesis (Friedman, 1957); the traditional models of the life-cycle hypothesis and the more recent buffer-stock theory of savings behavior (Deaton, 1991; Carroll, 1992).

Permanent Income Hypothesis was introduced by Friedman (1957) predicting that expectations of higher future income reduces current saving. This hypothesis introduces two components of income namely permanent income and transitory income, each of which undoubtedly has an effect on savings. Permanent income is described as expectation of the long time income over a planning period while transitory income is the difference between actual and permanent income. In the event of a windfall of today’s income, the hypothesis predicts that a higher savings will follow in order to sustain
tomorrow’s higher spending as well as guard against a decline of tomorrow’s income. Transitory income changes are met by consumption smoothing whereas permanent income changes do not justify an increase on current saving since more can be consumed now and in the future (Friedman, 1957).

However, in the Life Cycle Hypothesis from Ando and Modigliani (1963), consumption in a particular period is believed to depend on the expectations about lifetime income. This implies that savings is done to ensure smooth consumption throughout time. As there is a tendency for income to fluctuate systematically during one’s life; a person will become a net saver during their working years then later dis-savers in their retirement years. This consequently determines a person’s saving behavior. The macroeconomic implications of the LCH set it apart from the prevailing Keynesian theory at the time, which assumed that the saving income ratio was determined by level of income. It also implies that the aggregate private saving rate will also be influenced by income growth. Modigliani (1966, 1970) argues that a higher growth rate increases the total income of the working population relative to that of retired and dependent persons, thus raising the aggregate saving rate. The direction of causation from income growth to savings is strongly supported by Attanasio et al. (2000).

Another theory of savings brought forth by Deaton, 1991; Carroll, 1992 known as the buffer stock theory, posits the belief that the main reason consumers hold assets is to protect their consumption against any uncertainty or fluctuations in future income. The buffer stock behavior states that consumers are both impatient and prudent when faced with important income uncertainty. The theory describes impatience by stating that should incomes become certain, consumers would borrow against future income to finance current consumption and prudence would be due to their motives to safeguard and take precautionary measure. Carroll (1992) showed that these circumstances logically imply the existence of a target wealth stock. A wealth stock is determined by the consumers in such a way that whenever their wealth falls below the believed target, fear or prudence will dominate the impatience quality resulting in an effort to save. However, should wealth be above the chosen target, prudence is out ruled by impatience and consumers will most likely start to dis-save.

However, financial institutions operating in accordance with Islamic principles, their methodology for financing and deposits receiving are substantially different from conventional banks. Hence, based on Islamic teaching; Muslims must strictly follow the theory of Halal and Haram at any circumstances. Therefore, the interest and interest bearing activities are strictly prohibited (Haram) and those who are dealing in interest are fighting with Allah (SWT), the Holy Quran clearly mentioned this fact as follow;

“Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest.” Al-Quran (2: 275)

On the basis of above verse of Al-Quran, Muslims are obliged to follow the theory of Halal and Haram in any circumstances. According to the doctrine of Islam; the Muslim should avoid interest and invest their funds in Halal activities irrespective of
changes in interest rates (such changes in interest rates has no value to Muslims). The act of saving for descendants and next generation is highly appreciated in Islamic doctrine. Such as; Allah (SWT) clearly indicated this fact in the Holy Quran;

“And as for the wall, it belonged to two orphan boys in the city, and there was beneath it a treasure for them, and their father had been righteous. So your Lord intended that they reach maturity and extract their treasure, as a mercy from your Lord. And I did it not of my own accord. That is the interpretation of that about which you could not have patience.” Al-Quran (18: 82).

Theoretically there is controversy in the determinants of deposits and functions of deposits, such as the theories of saving in conventional and Islamic banking are conflicting. In addition, the empirical studies are not in full agreement for the unity or diversity of determinants of saving in conventional banks and Islamic banks. Thus, there is a need for further empirical investigation using different data and models.

3. Literature Review

There are fundamental differences between Islamic and conventional banks, such as conventional banks operating on interest based activities. While, on the other hand, Islamic banks are operating on Shariah complaint based interest free contracts. In certain regions, such as in Malaysia, Islamic banks are operating side by side with conventional banks in a dual banking system. Researchers have investigated, whether the deposits in Islamic banks are affected by conventional determinants or otherwise.

Recently a research was conducted by Etem and Bengul (2014), on the relationship between returns of interest based banks and Islamic banks in Turkey. They further investigated that whether Islamic banks rate of returns are affected by conventional deposit interest rates or not. The results show that Islamic banks are sensitive to conventional banks’ interest rates in Turkey. Furthermore, Diaw and Mbow (2011), compared the return on Mudarabah deposits (ROMD) and return on Equity (ROE) of nine Islamic banks from seven different countries, the study tried to investigate whether the return of these banks are correlated to conventional interest rates or otherwise. The results indicate that the ROE tend to be at least two times higher than the ROMD. In most of the investigated cases the ROMD are more correlated to the corresponding conventional interest rate than to ROE.

Kasri et al (2009), investigated the factors affecting saving in the Islamic banks of Indonesia. The results highlight the influential role of conventional interest rate in determining the level of saving in the Islamic banks. In particular, higher Islamic deposit is significantly correlated with higher rate of return and lower interest rate. In addition, the study found the existence of displaced commercial risk between the Islamic and conventional banks, such that the Islamic banks’ depositors transfer their funds to the conventional banks when the rate of return provided by the Islamic banks is significantly lower that the interest rate of its counterpart. In the same manner, Erwin and Kasri (2010) conducted a comparative study between Islamic and conventional banks of Indonesia. The study inspected the co-integration between bank margin and its determents of five
banks which included by two Islamic and three conventional banks. The result indicated that; there exists a long-run relationship between the Islamic bank margin and its determinants. In particular, as interest rate volatility increases, Islamic bank margin responds negatively while that of conventional banks responds positively. The paper further elaborated that the margin behavior changes as the basis of bank operations changes from conventional to Islamic principles.

Since Islamic banks are operating in certain regions in a dual banking system, the perception of the population regarding the Islamic banking may differ from one another. For instance, the perception of Muslim and non-Muslims towards Islamic banking may be different in certain countries or regions. To evaluate the bank patronage factors of Muslim and non-Muslim customers in Malaysia, an interesting study was done by Haron and Ahmad (1994). The purpose of the study was to determine the pertinent factors which Muslims and non-Muslims perceive as germane to their selection of banks. The most significant fact revealed by this study is that there is no significant difference in the selection criteria. In other words, both Muslims and non-Muslims who patronized commercial banks have a common perception in selecting their banks. With this information, the Islamic bank should not over emphasize, and rely on, the religion factor as a strategy to attract more customers. The Islamic bank should also be aware that only 40 per cent of Muslims believe that religion is the main factor in why people maintain an account with Islamic bank.

The study was supported by Rosly (1999), he investigated whether the interest rate changes will put Islamic banks at a disadvantage because of the dual banking system in Malaysia, as Islamic banks are over-dependent on fixed rate asset financing such as Murabahah and Bai Bithamanajil (BBA). The research found that, when interest rates are rising, rational product choice among non-Muslim customers is expected to produce a shifting effect that may frustrate deposit mobilization and at the same time deplete an Islamic bank’s earnings. The shifting effect occurs when non-Muslim customers either transfer deposits from Islamic banks to conventional banks, or, in a period of declining interest rates, opt for loans rather than for deferred sale financing. The researcher further elaborated that profit margins of Bank Islam Malaysia suffered a decline between the 1996-1997, due to rising interest rates while interest margins of conventional banks showed a rising trend.

Haron and Ahmad (2000) examined the effect of interest rates of deposit account facilities of conventional banks and past dividend rates of funds deposited by customers on the Islamic deposit facilities of Malaysian banks. Their findings confirmed that customers who place their deposits at saving and investment account facilities are guided by the profit motive. The existence of the utility maximization theory among the Muslim customers is further confirmed by the negative relationship between the interest rate of conventional banks and the amount deposited in interest-free deposit facilities. In the same manner, Bacha (2004) investigated whether Islamic banks operating within dual banking system in Malaysia may also be subjected to interest rate risk or not. The results were broadly consistent with the findings of Haron and Ahmad (2000).

Several determinants have impact on banking deposits, such as Haron and Azmi (2008), investigated the impact of selected economic variables on deposit level in the
Islamic and conventional banking systems in Malaysia, the research has found that; determinants such as rates of profit of Islamic bank, rates of interest on deposits of conventional bank, base lending rate, Kuala Lumpur composite index, consumer price index, money supply and gross domestic product have different impact on deposits at both Islamic and conventional banking systems. In most cases, customers of conventional system behave in conformity with the savings behavior theories. In contrast, most of these theories are not applicable to Islamic banking customers. Therefore, it is concluded that there is a possibility that religious belief plays an important role in the banking decisions of Muslim customers.

Kadom and Eid (2008), conducted a comparative study on the cost of capital of Islamic and conventional banks, the research investigated whether the cost of capital of Islamic banks may differ from its conventional counterpart or otherwise. The results indicated that; a high positive correlation coefficient was apparent between an Islamic bank’s market value and the size of its deposits, while the market value of Islamic banks was clearly independent of its cost of capital. The depositors favor Islamic banks due to Islam’s prohibition of fixed interest, regardless of the level of profit paid to their deposits. Furthermore, Islamic banks attempt to shadow the level of interest payments made to depositors at conventional banks, by reducing management fees on deposits whenever potential returns to depositors are viewed to be inadequate.

Abdul and Leong (2009) conducted a research on the impact of interest rate changes on the demand for Islamic financing in a dual banking system. The study found that any increase in the base lending rate would induce customers to obtain financing from Islamic banks and vice versa. The study further confirms that because customers are profit motivated, Islamic banks in the dual system are exposed to interest rate risks despite operating on interest free principles.

Kasim et al (2009) analyzed the impact of monetary policy shocks on the conventional and Islamic banks in a dual banking system. The study further determined the sensitivity of the Islamic banks by analyzing the impact of interest rate changes on the bank’s financing and deposits. The results were contrary to the general expectations and illustrated that Islamic bank’s balance sheet items are relatively more sensitive to monetary policy changes, while the conventional banks’ balance sheet items, particularly the conventional loans are insensitive to interest rate changes. This implies that the monetary policy has more destabilizing effects on Islamic banks than the conventional banks. More interestingly, the study found that the response of the Islamic deposit was significant and negative to interest rate changes.

The literature discussed the issue of Islamic and conventional banks in a dual baking system. Different researchers investigated the impact of interest rate and other factors on Islamic banks in different regions. Most of the above results were conflicting and were not in conformity with each other. Hence, it is important to further investigate this issue. This present research will investigate the impact of selected macroeconomic and bank-specific variables on Islamic banking deposits in Malaysian banking system.
Research Methodology

For the purpose of this study we have used time series techniques, particularly the “auto regressive distributive lag” ARDL approach to co-integration, Error correction model (ECM) in order to investigate the determinants of deposits in Islamic banks in Malaysia. The time series technique has several advantages over traditional regression method such as;

Firstly, regression analysis assumes theoretical relationship between variables but time series techniques test the theoretical relationship between variable through the co-integration test. Secondly, the regression analysis that has been applied for many decades to estimate the long-run relationship among economic and social variables is now considered to have either estimated a spurious relationship or estimated a short-run relationship. The damaging limitation of the traditional regression analysis (i.e., either spurious or not testing theory) has been addressed by the recent and ongoing co-integration time series techniques (Masih&Hamdan, 2008).

Thirdly, in traditional regression, the endogeneity and exogeneity of variables is pre-determined based on the assumption by the researcher, usually on the basis of prevailing or a priori theory. However, co-integration technique has advantages in that it does not presume variables’ endogeneity and exogeneity. Hence, the data will determine which variables are in fact exogenous, and which are endogenous. In other words, with regression, causality is presumed whereas in co-integration, it is empirically proven with the data (Masih&Hamdan, 2008).

Hence, we applied the ARDL approach to co-integration which has some advantages over other approaches. Firstly, this technique is comparatively more robust in small or finite samples consisting of 30 to 80 observations. Secondly, it can be utilized irrespective of whether regressors are of I(0) or I(1) or mutually integrated. There is still perquisite that none of the explanatory variables is of I(2) or higher order, i.e. the ARDL procedure will, however, be inefficient in the existence of I(2) or higher order series. Thirdly, the ARDL method applies general-to-specific modeling framework by taking sufficient number of lags to capture the data generating process (Pattichis, 1999; Mah, 2000).

The objective of this research is to find out the macroeconomic and bank-specific determinants of Islamic banking deposit (ID). Hence, for the purpose of our research two macroeconomic variables such as; industrial production index (as proxy for GDP growth) and Inflation (CPI), and two bank-specific variables such as, conventional interest rate (IR) and Islamic profit rate (IB) are examined.

The functional form of our model is as follow:

\[ ID = f (IPI, CPI, IR, IB) \]

Where:

ID= Islamic banking total deposits in Malaysia

IPI= Industrial Production Index (as proxy for GDP growth)
CPI = Consumer price index (as proxy for inflation)

IR = Conventional interest rate paid to deposits by banks in Malaysia

IB = Islamic profit rate paid to deposits by Islamic banks in Malaysia

The ARDL approach to co-integration involves estimating the unrestricted error-correction model. The Period of data covered was monthly data starting from January 2007 until December 2015, which includes 108 observations. The data was collected from the statistics website of central banks of Malaysia (BNM) and DataStream database.

4. Empirical Results and Discussions

To test for the existence of long-run relationship among variables we used the Autoregressive Distributive Lag (ARDL) approach. The results of long-run relationship indicate that, the F-statistics of LIR and LCPI are higher than the upper critical values (Pasaran, et al. 2001). This implies that there exists long-run relationship (co-integration) among variables. Hence, the bank specific and macroeconomic variables are co-integrated with Islamic banking deposit in Malaysia. Thus, the relationship which exist is not spurious relationship, but in contrast there is found a long-run relationship among given variables (Table 1).

| Table 1: Result of Long-Run Relationship Test in ARDL |
|-----------------|-----------------|-----------------|-----------------|
| Variables | F Statistics | Lower CV at 5* | Upper CV at 5* |
| LID | 1.6414 | 2.099 | 3.270 |
| LIBP | 1.9506 | 2.099 | 3.270 |
| LIR | 4.0170 | 2.099 | 3.270* |
| LIPI | 0.88489 | 2.099 | 3.270 |
| LCPI | 3.4493 | 2.099 | 3.270* |

* Lower and Upper Critical Values (CVs) are taken from Pesaran, Shin, & Smith (2001). The range of Lower and Upper CVs for 1% and 10% levels of significance are 2.607-3.888 and 1.840-2.964 respectively.

From our analysis so far, we have found that long-run relationship exist among the variables. However, the co-integrating equation reveals nothing about causality, that is, which variable is the leading variable and which is the laggard variable. Information on direction of Granger-causation can be particularly useful for banking industry regulators. By knowing which variable is exogenous and endogenous, regulators can better forecast or predict expected results of their policies.

Hence, the Error-correction model using ARDL approach will choose optimal lags for each variable separately. We select to use AIC as criteria for choice of ECM. Co-integration shows existence of long-term relationship, but sometimes there could be deviations from long-run in short-term relationships. Co-integration does not tell us much about short-run relationship and how it affects long-run relationship. Hence, the ECM explains effects of short-run influence on the long-run relationship. Those equations (variables) which have significant coefficient for their ecm(-1) are found to be dependent on other variables for determination of their values in short run that has long term effect, thus considered endogenous in the model. Conversely, those variables which don’t have
significant ecm(-1) coefficient do not depend on others for determination of value, thus considered exogenous in the model. In addition, the coefficient of the error-correction term tells us about the speed of short-run adjustment of the given variable.

The ECM results tell us that all variables except Islamic banking deposit rate (LID) and consumer price index (LCPI) are exogenous or leading variables. According to our findings LID and LCPI are the endogenous or follower variable, means that changes in the value of LID and CPI depends on changes in other exogenous variables. However, from the results it is obvious, that changes in industrial production index(LIPI), Conventional interest rate (LIR) and Islamic banking profit rate (LIBP) have significant impact on Islamic banking deposit rate (LID) in Malaysia. While, consumer price index (LCPI) is an endogenous (follower) variable and changes in its value depends on changes in other exogenous variables.

Moreover, the ECM produces a statistic that may be of interest to regulators. The coefficient of et-1 tells us how long it will take to get back to long term equilibrium if that variable is shocked. The coefficient represents proportion of imbalance corrected in each period. For instance, the coefficients for our all variables fall in between the -1 and 0 which indicates that there is partial adjustment in the long run (Table 2).

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>T-Statistics [P-Value]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ecm(-1) LID</td>
<td>-.053831</td>
<td>.026545</td>
<td>-2.0280 [.045]**</td>
</tr>
<tr>
<td>Ecm(-1) LIBP</td>
<td>-.080981</td>
<td>.10222</td>
<td>-.79225 [.430]</td>
</tr>
<tr>
<td>Ecm(-1) LIR</td>
<td>-.048872</td>
<td>.039869</td>
<td>-1.2258 [.223]</td>
</tr>
<tr>
<td>Ecm(-1) LIPI</td>
<td>-.12490</td>
<td>.077536</td>
<td>-1.6109 [.111]</td>
</tr>
<tr>
<td>Ecm(-1) LCPI</td>
<td>-.15561</td>
<td>.034252</td>
<td>-4.5432 [.000]*</td>
</tr>
</tbody>
</table>

Note: * and **denotes that coefficient is significant at 1% and 5% level respectively.

The results obtained from error correction model have established that most of our variables are exogenous (except ID and CPI), these empirical results will have significant implications for banking regulators in Malaysia; among the macroeconomic and bank specific variables the industrial production index (IPI as proxy for GDP growth), conventional interest rate (IR) and Islamic banking profit rate has greater influence on Islamic banking deposits. While, consumer price index (CPI as proxy for inflation) has no influence on Islamic banking deposits in Malaysia. This indicates that, any increase in IPI will ultimately increase the Islamic banking deposits. In the same manner, the high Islamic profit rate will attract more deposits to Islamic banks and visa-versa. However, since the customers of Islamic banks in Malaysia are divided into the categories of Muslim and non-Muslim, which confirm that t religion is not the only factor of why people maintain account in Islamic banks (Haron and Ahmad, 1994). Thus, an increase in conventional interest rates will negatively impact Islamic banking deposits, i.e. by increasing conventional interest rates asin compared to Islamic banking profit rates the non-Muslim depositors of Islamic banks will transfer their funds to conventional banks and visa-versa.
5. Conclusion and Policy Implications

This study has investigated the impact of selected macroeconomic and bank-specific determinants on Islamic banking deposit in Malaysia. Based on the results we have concluded as follow;

1. According to our results, bank specific variables such as; conventional interest rate and Islamic profit rate both have impact on Islamic banking deposit in Malaysian banking system. This fact indicates that Islamic banking customers are being guided by the profit motive; hence the profit maximization theory exists among the Muslim customers too. Therefore, as a policy implication the regulators must strictly supervise Islamic banks to invest their funds in highly profitable projects. Central bank must make sure that Islamic banks can provide high profit rates to their customers in comparison to conventional banks. This will pave the way for sustainable performance and development of Islamic banks in long-run.

2. Furthermore, based on our results among the macro-economic variables industrial production index (IPI as proxy for GDP growth) has strong impact on Islamic banking deposits in Malaysian banking system. Such as, an increase in IPI will increase the level of deposits in Islamic banks accordingly. On the other hand inflation (CPI) as another macro-economic variable has no significant impact on the determination of Islamic banking deposits. Hence, since Islamic banking depositors are being guided by the profit motive, changes in inflation will not significantly change their intention toward depositing in Islamic banks until Islamic banks provide them high profit rate in comparison to their conventional counterparts. Therefore, as a policy implication the government of Malaysia has to maintain the upward trend of IPI by increasing investment in infrastructure projects, international trade etc. which will ultimately increase Islamic banking deposits accordingly.

3. Our findings indicate that by increasing interest rate of conventional banks the Islamic banking deposit rate will decrease accordingly. This fact is elaborated by Rosly (1999), who made a distinction between the Malaysian banks customers in to the category of Muslim and non-Muslim. Such as, when interest rates are rising, rational product choice among non-Muslim customers is expected to produce a shifting effect that may frustrate deposit mobilization and at the same time deplete an Islamic bank’s earnings. The shifting effect occurs when non-Muslim customers transfer deposits from Islamic banks to conventional banks. Thus, since the customers of Islamic banks in Malaysia are divided into the categories of Muslim and non-Muslim, which confirm that, religion is not the only factor in why people maintain account in Islamic banks. Furthermore, we further confirm the findings of (Bacha, 2004), that Islamic banking customers are being guided by the profit motive, and the profit maximization theory exists among the Muslim customers too. Therefore, as policy implication the regulators and Islamic banks must invest more on public awareness of their Muslim customers regarding the Shariah compliant products and the doctrine of Halal and Haram. This will help Islamic banks to maintain their customer even if the profit given to the deposits are lower than conventional banks interest rate.
References

Al-Quran


Bank Efficiency: Islamic and Conventional Banks in Malaysia

By
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Syukriah Ali, Najah Mokhtar & Kartini Kasim

Abstract

The main objective of this study is to determine the factors affecting banking efficiency and to compare bank efficiency between Islamic and conventional banks in Malaysia. A total of 16 Islamic banks and 27 conventional banks in Malaysia were analysed to achieve the objectives. Ordinary Least Squares (OLS) was used to determine the factors that affect banking efficiency while Levene’s Test were applied to compare the banking efficiency between Islamic and conventional banks in Malaysia. The results reveal that five variables, which are Level of Capitalization (CPT), Credit Risk (CR), Riskiness of Bank (RB), Return on Asset (ROA) and Bank Size (BS) affect the banking efficiency of Islamic banks. However, only four variables affect the banking efficiency of conventional banks, which are Level of Capitalization (CPT), Riskiness of Bank (RB), Return on Asset (ROA) and Bank Size (BS). Overall, Levene’s Test shows that conventional banks are more efficient than Islamic Banks.

Keywords: Islamic banks, Conventional banks, Malaysia, Bank Efficiency, Return on Average Equity, OLS, SPSS

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1.0 Introduction

Malaysia has been successful in operating both Islamic and conventional banks. It is the first state to hold a full-fledged Islamic banking system operating alongside with the conventional banking system. Islamic banking refers to a system of banking that complies with Islamic law, also known as Shari’ah law. The Islamic financial transactions date from the spread of Islam 14 centuries ago, but no institution performed or worked at that time as a bank. The underlying rules that govern Islamic banking are mutual risk and profit sharing between the supplier of capital (investor) and the use of funds (entrepreneur). In other words, it assures an equal contribution for all parties involved, whether in profitability or in case of any loss occurred. Any activities that involve interest (riba), gambling (mairis) and speculative trading (gharar) are prohibited. In contrast, conventional banking is based on a purely financial model. This means that banks mainly borrow from depositors and lend to enterprises or individuals. In this system, conventional banks make profit through the different rates of interest by borrowing and lending of money.

Bank efficiency is very important in order to obtain more profit to cover expenses. Thus, to determine the factors that affect banking efficiency and to compare efficiency between Islamic and conventional banks in Malaysia, this study used Return on Average Equity (ROAE) as a dependent variable. ROAE indicates the return to shareholders on their equity. Investors want to experience a high return on equity ratio because this indicates the bank is using their investors' funds effectively. Higher ratios are nearly invariably safer than lower ratios, but have to be compared to other banks' ratios in the diligence. Many investors prefer to compute the return on average equity at the beginning of a period and at the end of a period in order to see the change in return.

Independent variables in this study are the level of capitalization, liquidity risk, credit risk, riskiness of the bank, return on assets and bank size. Level of capitalization tells the investors about the extent to which the depository financial institution is using its equity to sustain its operations and development. This ratio helps in the assessment of risk. The bank with high capitalization ratios are considered to be risky because they are at a risk of insolvency if they neglect to repay their debt on time. Bank with a high capitalization ratio may also find it difficult to get more loans in the future. A high capitalization ratio is not always bad; however, higher financial leverage can increase the return on a shareholder’s investment because usually there are tax advantages associated with the borrowings.

Liquidity risk is the risk that a bank may be unable to meet short term financial demands. This usually happens due to the inability to convert a security or hard asset to cash without a loss of capital or income in the operation. According to Vento and Ganga (2009), liquidity symbolized the ability of banks to compare the balance of inflow and outflows over time. With the existence of liquidity risk, banks need to be cautious with the cash flow that that impact bank profits, which affects their efficiency. Credit risk refers to the risk that a borrower may not repay a loan and that the lender may lose the principal of the loan or the interest associated with it. Credit risk arises because borrowers expect to use future cash flows to pay current debts, which it is almost never possible to ensure that they will definitely have the funds to repay the debts. Furthermore,
according to Chen (2009), credit risk is another factor that probably changes a bank’s efficiency scores when it operates at similar risk level and business areas as other banks. Return on assets (ROA) gauges how efficiently a company can squeeze profit from its assets, regardless of size. A high ROA is a sign of solid financial and operational performance. Riskiness of bank and bank size show how the strength of the bank stands, although there are several financial crises which have a big impact on currency, exchange rate and monetary policy.

The aim of this study is to determine which factors - level of capitalization, liquidity risk, credit risk, riskiness of the bank, return on assets and bank size - affect banking efficiency of Islamic and conventional banks. Also, it aims to compare the efficiency between Islamic and conventional banks in Malaysia.

2.0 Literature Review

2.1 Bank efficiency

Bank specific characteristics include bank size, equity over total assets, return on assets or equity, loans-to-total assets, bank configuration and type of ownership. In the past, studies on Islamic banking efficiencies have been undertaken worldwide (Shahid, Rehman, Niazi, & Raoof, 2010). There have been a limited number of studies on the efficiency of Islamic banks rather than conventional banks. Few studies concerning the comparison of efficiency between Islamic and conventional banks in Malaysia exist (Noor & Ahmad, n.d.). Studies on comparison of the efficiency between Islamic and conventional banks have been undertaken in recent years. Ismail, Abd. Majid, and Ab. Rahim (2013) discovered that for Islamic banks, the main contributor for cost efficiency is allocative efficiency and for conventional banks, the main contributor for cost efficiency is technical efficiency. Their findings indicated that conventional banks have been efficient in utilizing information technology and electronics while Islamic banks conversely have been efficient in allocating and utilizing their resources. According to Rosman, Wahab and Zainal (2014), majority of Islamic banks were scale inefficient while Ahmad and Abdul Rahman (2012) stated that the conventional bank is better than Islamic banks in all efficiency measures due to managerial efficiency and technological advancement. On the other hand, findings of Yahya, Muhammad, and Hadi (2012) show that there is no significant difference in the level of efficiency between Islamic and conventional banks. Other study found that banks with higher return on equity (ROE) were more efficient than lower ROE (Sanchez, Hassan, & Bartkus, 2013).

2.2 Level of capitalization

It was documented by Ismail et al. (2013), the level of capitalization is significantly and positively associated with efficiency of both Islamic and conventional banks. The result is supported by several researches. Fakarudin Kamarudin (2016) found a significant influence of capitalization for revenue efficiency of domestic Islamic banks operated in Malaysia, while Palečková (2015) found that the level of capitalization is positively significant to the efficiency of the Czech commercial banks. This is consistent with study done by Pasiouras and Kosmidou (2007) on foreign and domestic commercial banks in European Union, where the equity to assets ratio was positively related with efficiency of domestic or foreign banks and it appeared to be the most significant factor
influencing efficiency of domestic banks. The Significant differences were found for the level of capitalization between Islamic and conventional banks efficiency (Wasiuzzaman & Nair, 2013). Level of capitalization was also found to have a strong relationship with banking efficiency using parsimonious model (Zolkifli, Hamid, & Janor, 2015).

2.3 Liquidity risk

According to Imbierowicz and Rauch (2014), liquidity risk, credit risk and management risk are the influences of various types of risk that have been considered in some studies. Aghimien, Kamarudin, Hamid, and Noordin (2016) found that the liquidity significantly influences the revenue efficiency of domestic Islamic banks operating in Malaysia, Indonesia and Brunei during the period under research. The finding is consistent with Wasiuzzaman and Nair (2013) in the case of Islamic and conventional banks in Malaysia. Palečková (2015) determined that liquidity risk had a positive impact on banking efficiency. In contrast, the result from Ariffin and Kassim, (2001) indicated that liquidity risk is not significant across all banks and have no impact on banking efficiency. In order to achieve a better performance from the emergence of new risk factor in banking activities, there was a need for financial risk expertise to undertake risk assessment both at individual institution level as well as on a system-wide basis (Bank Negara Malaysia [BNM], 2016).

2.4 Credit risk

Another determinant that might considerably change a bank’s efficiency scores when used in similar risk level and business areas as other banks is credit risk (Chen et al., 2009). By referring to Ariff and Can (2008), higher ratio of loan to total asset indicates that higher credit risk is incurred by banks. Thus, these banks would have higher non-performing loans resulting their being less efficient. In contrast, banks which provide more loans are also expected to be more efficient in profit as they take more risks.

Other studies showed different result where they found that credit risk has a significant positive relationship with bank efficiency which indicates that the banks’ output is favorable to promote efficiency. It was found that credit risk has a significant positive relationship with both performance and efficiency with an indication that the banks’ output mix is favourable to promote efficiency.

Therefore, banks that would be taking more risks and become more efficient show that they have a higher number of non-performing loans (Srairi, 2013). It could be observed that efficiency would be better for conventional banks with the decrement of credit risk (Rozzani & Rahman, 2013). Surprisingly, it was found that the credit risk had a significant positive effect on both overall technical efficiency, scale efficiency and pure technical efficiency for Asia Islamic banks (Rosman et al., 2014).

On the contrary, the previous studies found negative relationship between problem loans and bank efficiency. Pooled OLS method shows that net loan to total asset was not the significant variables affecting the performance of Islamic banks in Malaysia (Abduh & Alias, 2014).
2.5 Riskiness of bank

The greater risk reduction are required for adequate capital and reserve, appropriate pricing and control of risks, strong rules and practices for governance, disclose, accounting and auditing rules, and suitable infrastructure that could facilitate liquidity management (Sundararajan & Errico, 2002). The results by Palečková (2015) showed that the measure in assumption of constant return to scale, the riskiness of bank has a positive impact on efficiency. Abduh and Alias (2014) examined the result of Pooled OLS method and discovered that loan loss provision to total assets is the significant variable affecting the performance of Islamic and conventional banks in Malaysia. This indicates that both type of banks do not have much difference in focusing to their main business that is providing loan or financing. Ismail et al. (2013) found that loan quality is significant and negatively related with efficiency of Islamic and conventional banks. The investigation determined that conventional banks with higher loan provisions have lower efficiency level.

2.6 Return on assets

ROA (as measured by Net Income after Tax to Total Assets) has a positive sign. This factor was used to determine the profit of Libyan banks where the result indicated that the more profitable a bank, the more efficient it is (Alrafadi, Yusuf, & Kamaruddin, 2015). It also showed that ROA was significantly related to technical efficiency at 95% confidence level. It is further found that there is a positive association of ROA with profitability efficiency of Islamic banks. The finding was consistent with other result on technical efficiency (Darrat, Topuz, & Yousef, 2002). Palečková (2015) on the other hand stated that ROA had a negative impact on banking efficiency. This result might be due to the pattern of efficiency levels in Malaysia where some banks with high efficiency levels experience decreasing returns of scale (Ahmad & Abdul Rahman, 2012). The increase in cost will lead to the lower profitability for efficient banks.

2.7 Bank size

Ismail et al. (2013) found that bank size for conventional banks is significantly and positively associated with efficiency. This means that the larger banks tend to achieve higher efficiency. It was found that the bank size significantly influences the revenue efficiency of domestic Islamic banks operating in Malaysia, Indonesia and Brunei during the period under research. Wasiuzzaman and Nair (2013) found there are significant differences between the Islamic and conventional banks for bank size. On the other side, (Palečková et al., 2015) was recovered that there is a negative effect of bank size on banking efficiency. The result by Abduh and Alias (2014) from Pooled OLS method showed that loan bank size is not a significant variable affecting the Islamic banks performance in Malaysia. Consequently, bank size for Islamic banks is negatively associated with efficiency. This result was supported by Darrat et al.(2002) who said that the small banks become more managerially aggressive and cost efficient in order to survive which resulted in a negative relationship between bank size and efficiency. Another study argued that the relationship between bank size and the efficiency of Islamic banks does not mean that large banks should not attain their favorable size, where inadequate size measure is caused by the proportion of their productive inefficiency.
However, it was dropped from the analysis because the size of Islamic banks in Malaysia had insignificant contribution to bank efficiency. Moreover, the profit of Islamic banks in Malaysia are not influenced by the size of banks (Ramlan & Adnan, 2016).

Based on the literature review addressed, the followings hypotheses are developed for this study:

H1: At least one factor between level of capitalization, liquidity risk, and credit risk, riskiness of bank, return on assets and bank size affect Islamic bank’s efficiency.

H2: At least one factor between level of capitalization, liquidity risk, and credit risk, riskiness of bank, return on assets and bank size affect conventional bank’s efficiency.

H3: Conventional banks are more efficient than Islamic banks.

3.0 Methodology

3.1 Data collection and samples

This study uses panel data in which the data is obtained from Bankscope. As a sample of the study 16 Islamic banks and 27 conventional banks in Malaysia were selected for further analysis. The study period is 10 years starting from 2006 until 2015. The dependent variable is bank efficiency while the independent variables are level of capitalization, liquidity risk, credit risk, riskiness of bank, return on asset and bank size. The data is then analysed using e-view 9 and SPSS 21. Table 1 shows the measurement of the variables of the study.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Represent by</th>
<th>Proxy variables</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity risk</td>
<td>LR</td>
<td>= loan/deposit</td>
<td>Iveta Repkova et al. (2015)</td>
</tr>
<tr>
<td>Credit risk</td>
<td>CR</td>
<td>= loan/asset</td>
<td>Iveta Repkova et al. (2015)</td>
</tr>
<tr>
<td>Riskiness of banks</td>
<td>RB</td>
<td>= loan loan provision /total asset</td>
<td>Ahmad Mokhtar (2007)</td>
</tr>
<tr>
<td>Bank size</td>
<td>BS</td>
<td>= total asset</td>
<td>Darrat et al.(2002), Abdul Majid (2003) and Ahmad, Mokhtar et al. (2007)</td>
</tr>
</tbody>
</table>

3.2 Analysis of data

First, descriptive statistical analysis is used to describe the mean, median and standard deviation of the study. Then, correlation analysis was performed to diagnose the multicollinearity problem. Next, three different panel data models; pooled effect, fixed
effect estimation and random effect estimation are used in order to analyse panel data. The basic panel data model for panel data is as follows:

\[
\text{Bank Efficiency} = \alpha + \beta_1 \text{CPT} + \beta_2 \text{LR} + \beta_3 \text{CR} + \beta_4 \text{RB} + \beta_5 \text{ROA} + \beta_6 \text{BS} + \epsilon
\]

CPT = Level of capitalization
LR = Liquidity Risk
CR = Credit Risk
RB = Riskiness of Banks
ROA = Return on Asset
BS = Bank Size

After that, model specification tests which are Likelihood Ratio, Lagrange Multiplier Test and Hausman Test were used to choose the appropriate model in order to achieve the first objective. Finally, Levene's Test for Equality of Variances analysis was used to achieve the second objective that is to compare the bank’s efficiency between Islamic and conventional banks in Malaysia. In order for the comparison to be more reliable and meaningful, Levene’s test for equality of variances is used. If the Levene’s Test is significant (the value under "Sig." is less than .05), the two variances are significantly different. If it is not significant (Sig. is greater than .05), the two variances are not significantly different; that is, the two variances are approximately equal.

4.0 Results and Discussion

4.1 Descriptive statistical analysis

Table 2 Descriptive statistical analysis for Islamic and Conventional banks

<table>
<thead>
<tr>
<th>Variables</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROAE</td>
<td>160</td>
<td>9.3013</td>
<td>7.6517</td>
<td>-33.4000</td>
<td>27.3130</td>
</tr>
<tr>
<td>CPT</td>
<td>160</td>
<td>8.4428</td>
<td>6.1805</td>
<td>3.1870</td>
<td>77.1810</td>
</tr>
<tr>
<td>LR</td>
<td>160</td>
<td>97.7074</td>
<td>31.2687</td>
<td>5.8400</td>
<td>230.8900</td>
</tr>
<tr>
<td>CR</td>
<td>160</td>
<td>70.2799</td>
<td>27.5335</td>
<td>0.8260</td>
<td>230.8900</td>
</tr>
<tr>
<td>RB</td>
<td>160</td>
<td>0.0024</td>
<td>0.0058</td>
<td>-0.0114</td>
<td>0.0669</td>
</tr>
<tr>
<td>ROA</td>
<td>160</td>
<td>0.0043</td>
<td>0.0218</td>
<td>-0.0257</td>
<td>0.0172</td>
</tr>
<tr>
<td>BS</td>
<td>160</td>
<td>21086451</td>
<td>24239980</td>
<td>291376.0</td>
<td>1.56E+08</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variables</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROAE</td>
<td>270</td>
<td>11.2674</td>
<td>7.2966</td>
<td>-13.3300</td>
<td>37.3900</td>
</tr>
<tr>
<td>CPT</td>
<td>270</td>
<td>13.3034</td>
<td>13.0553</td>
<td>0.0000</td>
<td>99.4600</td>
</tr>
<tr>
<td>LR</td>
<td>270</td>
<td>58.8975</td>
<td>30.3392</td>
<td>0.0000</td>
<td>266.4300</td>
</tr>
<tr>
<td>CR</td>
<td>270</td>
<td>47.6707</td>
<td>21.4791</td>
<td>0.0000</td>
<td>75.0100</td>
</tr>
<tr>
<td>RB</td>
<td>270</td>
<td>0.0021</td>
<td>0.0035</td>
<td>-0.0040</td>
<td>0.0394</td>
</tr>
<tr>
<td>ROA</td>
<td>270</td>
<td>0.0096</td>
<td>0.0078</td>
<td>-0.0551</td>
<td>0.0548</td>
</tr>
<tr>
<td>BS</td>
<td>270</td>
<td>66320044</td>
<td>1.04E+08</td>
<td>0.000000</td>
<td>7.08E+08</td>
</tr>
</tbody>
</table>
Table 2, Panel A and B present the descriptive statistics of the variables which is the mean values, standard deviation, minimum and maximum values of the variables for the Islamic and conventional banks in Malaysia. These statistics provide information regarding variable distribution. Specifically, mean value is a measure of the average of the underlying variables over the study period. Standard deviation describes how much a variable shows variation or diversification from the average value. Minimum (Min) and maximum (Max) values indicate lowest and highest value in the sample. All variables have positive means over the studied period.

The mean return on average equity (ROAE) for Islamic banks is lower than conventional banks which is 9.3013 and 11.2374 respectively. However the standard deviation of ROAE for Islamic banks is slightly higher than conventional banks which is 7.6517 and 7.2966. The minimum and the maximum values of ROAE for Islamic banks are ranging from -33.4000 to 27.3130 while for conventional banks is -13.3300 and 39.3900. This indicates that conventional banks are creating more income for each ringgit of stockholders’ equity as compared to Islamic banks and are more efficient in utilizing shareholders fund to create income for the shareholders as compared to Islamic banks. The mean level of capitalization (CPT) of Islamic banks is 8.4428 whereas it is 13.3034 for conventional banks. The high ratio may be due to the fact that the conventional banks are risky as compare to Islamic banks. The mean liquidity risk (LR) of Islamic banks is 97.7074 and 58.8975 for conventional banks. These indicate that Islamic banks face relatively higher liquidity risk than conventional banks. In addition, higher liquidity risk may be due to Islamic banks not having enough liquidity to cover any unforeseen fund requirements. The mean credit risk (CR) of conventional banks is 47.6707. Alternatively, mean credit risk (CR) of Islamic banks is 70.2799 which is higher than conventional banks. This implies that there is a higher potential that Islamic bank’s borrower will fail to pay back the loan accordingly. The mean riskiness of bank (RB) and standard deviation of conventional banks is 0.0021 and 0.0035 respectively. However the mean (0.024) and standard deviation (0.058) is slightly higher for Islamic bank. This shows that conventional bank set aside higher amount of loan loss provision as an allowance for uncollected loans and loan payments compared to Islamic banks. Therefore, it is suggested that conventional banks has lower risk compared to Islamic banks. Moreover, this provision is used to cover a number of factors associated with potential loan losses including bad loans, customer defaults and renegotiated terms of a loan that incur lower than previously estimated payments. The minimum and the maximum values of the RB for Islamic banks are -0.0114 and 0.0669 while the minimum and the maximum values of the RB for conventional banks are -0.0040 and 0.0394. The mean return on asset (ROA) and standard deviation of Islamic banks is 0.043 and 0.0218 respectively. The mean return on asset (ROA) and standard deviation of conventional banks is 0.096 and 0.0078 respectively. The lower value indicates that Islamic banks have lower profitability relative to its total assets than conventional banks. The minimum and the maximum values of ROA for Islamic banks are -0.2578 and 0.0172. Alternatively, conventional banks are -0.0551 and 0.0548. It is suggested that both banks have negative return (loss) throughout the study period but Islamic banks incurred higher losses than conventional bank. Finally, considering total asset as a proxy of bank size, mean of bank size (BS) for Islamic banks is 2108615. Meanwhile conventional bank is 66320044. Thus, it indicates that the total assets of Islamic banks are lower compared to conventional bank.
4.2 Correlation Analysis

Table 3: Correlation analysis for Islamic and Conventional banks

<table>
<thead>
<tr>
<th>Variable</th>
<th>ROAE</th>
<th>CPT</th>
<th>LR</th>
<th>CR</th>
<th>RB</th>
<th>ROA</th>
<th>BS</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROAE</td>
<td>1.000000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPT</td>
<td>-0.628136</td>
<td>1.000000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LR</td>
<td>0.002716</td>
<td>-0.104942</td>
<td>1.000000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR</td>
<td>0.134004</td>
<td>-0.227229</td>
<td>0.791870</td>
<td>1.000000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RB</td>
<td>-0.414579</td>
<td>0.049142</td>
<td>0.060134</td>
<td>-0.139673</td>
<td>1.000000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA</td>
<td>0.662964</td>
<td>-0.695092</td>
<td>0.196253</td>
<td>0.212944</td>
<td>-0.156091</td>
<td>1.000000</td>
<td></td>
</tr>
<tr>
<td>BS</td>
<td>0.427545</td>
<td>-0.185657</td>
<td>0.272506</td>
<td>0.326823</td>
<td>-0.118185</td>
<td>0.146339</td>
<td>1.000000</td>
</tr>
</tbody>
</table>

Panel A: Correlation analysis for Islamic banks

| ROAE     | 1.000000 |     |    |    |    |     |    |
| CPT      | -0.577037 | 1.000000 |     |    |    |     |    |
| LR       | 0.278302 | -0.160676 | 1.000000 |    |    |     |    |
| CR       | 0.503299 | -0.400750 | 0.773199 | 1.000000 |    |     |    |
| RB       | 0.016870 | -0.096681 | 0.147746 | 0.256384 | 1.000000 |    |     |
| ROA      | 0.566995 | -0.606992 | 0.141256 | 0.231556 | -0.073161 | 1.000000 |    |
| BS       | 0.338596 | -0.259542 | 0.260344 | 0.389636 | 0.100802 | 0.115806 | 1.000000 |

Panel B: Correlation analysis for conventional banks

Table 3, Panel A & B are the result of the correlation analysis for Islamic and conventional banks. The purpose of analysing the correlation analysis is to determine the multi-collinearity problem. Based on the overall result, the values of correlation matrix among independent variables are less than \( r=0.80 \), thus it can be concluded that there is no problem of multi-collinearity.

4.3 Pooled effect, fixed effect estimation and random effect result

Table 4: Pooled effect, fixed effect estimation and random effect – Islamic banks

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>t-Statistic</th>
<th>Coefficient</th>
<th>t-Statistic</th>
<th>Coefficient</th>
<th>t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>-161.2030</td>
<td>-6.141415</td>
<td>-276.9966</td>
<td>-4.846670</td>
<td>-196.0617</td>
<td>-6.464243</td>
</tr>
<tr>
<td>CPT</td>
<td>-0.072735</td>
<td>-0.422493</td>
<td>1.151109***</td>
<td>5.216326</td>
<td>0.389767</td>
<td>2.375117</td>
</tr>
<tr>
<td>LR</td>
<td>-0.027623</td>
<td>-1.179622</td>
<td>0.028441</td>
<td>1.003542</td>
<td>-0.021621</td>
<td>-1.010681</td>
</tr>
<tr>
<td>CR</td>
<td>-0.000356</td>
<td>-0.013314</td>
<td>-0.075922***</td>
<td>-2.124396</td>
<td>-0.003355</td>
<td>-0.128650</td>
</tr>
<tr>
<td>RB</td>
<td>-412.6346***</td>
<td>-5.398879</td>
<td>-218.0503***</td>
<td>-3.420022</td>
<td>-351.0888</td>
<td>-6.098644</td>
</tr>
<tr>
<td>ROA</td>
<td>113.1876**</td>
<td>2.464384</td>
<td>360.3932***</td>
<td>6.879343</td>
<td>200.0330</td>
<td>4.844809</td>
</tr>
</tbody>
</table>

Notes: *** , ** , * Significant at 1, 5 and 10% levels, respectively
From Table 4, pool effect model shows that riskiness of banks, return on assets and bank size have significant effect towards Islamic banking efficiency. The estimation model result is specified as below.

\[
\text{Bank Efficiency} = -161.2030 - 0.072735CPT_1 - 0.027623LR_2 - 0.000356CR_3 - 412.6346RB_4 + 113.1876ROA_5 + 62.2750BS_6
\]

Fixed effect model shows that level of capitalization, riskiness of banks, credit risk, return on assets and bank size have significant effect towards Islamic banking efficiency. The estimation model result is specified as below.

\[
\text{Bank Efficiency} = -276.9966+ 1.151109CPT_1+0.028441LR_2 - 0.075922CR_3– 218.0505RB_4 + 360.3932ROA_5 + 99.1183BS_6
\]

Random effect model shows that level of capitalization, riskiness of banks, return on assets and bank size have significant effect towards Islamic banking efficiency. The estimation model result is specified as below.

\[
\text{Bank Efficiency} = -196.0617 + 0.389767CPT_1 – 0.021621LR_2 – 0.003355CR_3 – 351.0888RB_4 + 200.0330ROA_5 + 72.8523BS_6
\]

Table 5: Ordinary Least Square – Conventional Banks

dependent variable: return on average equity (ROAE)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Pool Effect Coefficient</th>
<th>Pool Effect t-Statistic</th>
<th>Fixed Effect Coefficient</th>
<th>Fixed Effect t-Statistic</th>
<th>Random Effect Coefficient</th>
<th>Random Effect t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>-94.75021</td>
<td>-6.126106</td>
<td>139.7024</td>
<td>2.669249</td>
<td>-73.60173</td>
<td>-3.118862</td>
</tr>
<tr>
<td>CPT</td>
<td>0.035515</td>
<td>0.658629</td>
<td>-0.200262**</td>
<td>-2.278170</td>
<td>-0.000107</td>
<td>-0.001724</td>
</tr>
<tr>
<td>LR</td>
<td>-0.027267</td>
<td>-1.557425</td>
<td>-0.005086</td>
<td>-0.293373</td>
<td>-0.013841</td>
<td>-0.855351</td>
</tr>
<tr>
<td>CR</td>
<td>0.063964**</td>
<td>2.040049</td>
<td>-0.036271</td>
<td>-0.836783</td>
<td>0.021310</td>
<td>0.625954</td>
</tr>
<tr>
<td>ROA</td>
<td>395.6153***</td>
<td>7.108186</td>
<td>324.9650***</td>
<td>5.575335</td>
<td>377.8347</td>
<td>7.190982</td>
</tr>
<tr>
<td>LN_BS</td>
<td>35.84528**</td>
<td>6.551639</td>
<td>44.60515**</td>
<td>2.420390</td>
<td>28.97513</td>
<td>3.442572</td>
</tr>
</tbody>
</table>

Notes: *** , ** , * Significant at 1, 5 and 10% levels, respectively

From Table 5, pool effect model shows that credit risk, riskiness of banks, return on assets and bank size have significant effect towards conventional banking efficiency. The estimation model result is specified as below.

\[
\text{Bank Efficiency} = -94.75021+ 0.035515CPT_1 - 0.027267LR_2+0.063964CR_3 - 190.8399RB_4 + 395.6153ROA_5 + 35.84528BS_6
\]

Fixed effect model shows that level of capitalization, credit risk, return on assets and bank size have significant effect towards conventional banking efficiency. The estimation model result is specified as below.

\[
\text{Bank Efficiency} = 139.7024- 0.200262CPT_1 - 0.005086LR_2 - 0.036271CR_3 – 395.0364RB_4 + 324.9650ROA_5– 44.60515BS_6
\]

Random effect model shows that level of capitalization, riskiness of banks, return on assets and bank size have significant effect towards conventional banking efficiency. The estimation model result is specified as below.
Bank Efficiency = -196.0617 + 0.389767CPT1 – 0.021621LR2 – 0.003355CR3 – 351.0888RB4 + 200.0330ROA5 + 72.85234BS6

### 4.4 Model Specification Test Results

<table>
<thead>
<tr>
<th>Test</th>
<th>Islamic Banks</th>
<th>Conventional banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Likelihood Ratio</td>
<td>7.282601***</td>
<td>5.443801***</td>
</tr>
<tr>
<td>Lagrange Multiplier</td>
<td>20.19795***</td>
<td>72.49512***</td>
</tr>
<tr>
<td>Hausman Test</td>
<td>39.036267***</td>
<td>28.945183***</td>
</tr>
</tbody>
</table>

Table 6 shows the specification test result for Islamic banks and conventional banks. It was found that the Likelihood Ratio and Hausman Test demonstrate similar results for Islamic and conventional banks. Therefore, it can be concluded that Fixed Effect model is an appropriate model of this study.

### Table 7: Fixed Effect Model – Islamic banks and Conventional banks

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>t-Statistic</th>
<th>Coefficient</th>
<th>t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Islamic Banks</td>
<td>(b) Conventional banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>-276.9966</td>
<td>-4.846670</td>
<td>139.7024</td>
<td>2.669249</td>
</tr>
<tr>
<td>CPT</td>
<td>1.151109***</td>
<td>5.216326</td>
<td>-0.200262**</td>
<td>-2.278170</td>
</tr>
<tr>
<td>LR</td>
<td>0.028441</td>
<td>1.003542</td>
<td>-0.005086</td>
<td>-0.293373</td>
</tr>
<tr>
<td>CR</td>
<td>-0.075922***</td>
<td>-2.124396</td>
<td>-0.036271</td>
<td>-0.836783</td>
</tr>
<tr>
<td>RB</td>
<td>-218.0503***</td>
<td>-3.420022</td>
<td>-395.0364***</td>
<td>-4.422850</td>
</tr>
<tr>
<td>ROA</td>
<td>360.3932***</td>
<td>6.879343</td>
<td>324.9650***</td>
<td>5.575335</td>
</tr>
<tr>
<td>LN_BS</td>
<td>99.11835***</td>
<td>4.894068</td>
<td>-44.60515**</td>
<td>-2.420390</td>
</tr>
</tbody>
</table>

Table 7(a) shows the fixed effect result of Islamic banks. The R² is relatively high, about 89%. It indicates that 89% variations of banking efficiency can be explained by the variations in independent variables which are level of capitalization, liquidity risk, credit risk, riskiness of bank, return on assets and bank size while the remaining of 11% were explained by other factors that are not included in this study. F-statistic describes the overall fitness of the model. The test statistics is F (30.85) with p-value (0.0000) which is less than alpha, α (0.05), supports the claimed hypothesis which is at least one of the
factors which are level of capitalization, liquidity risk, credit risk, riskiness of bank, return on assets and bank size will influence banking efficiency. T-test result shows that there are five variables that have significant p-value less than alpha, \( \alpha (0.05) \) which are level of capitalization, credit risk, riskiness of bank, return on assets and bank size. It can conclude that level of capitalization, credit risk, riskiness of bank, return on assets and bank size have significant effect on Islamic banks efficiency and thus, \( H_1 \) is accepted.

The following equation model has been generated for this study.

\[
\text{Bank Efficiency} = -276.9966 + 1.151109\text{CPT}_1 + 0.028441\text{LR}_2 - 0.075922\text{CR}_3 - 218.0505\text{RB}_4 + 360.3932\text{ROA}_5 + 99.1183\text{BS}_6
\]

Table 7(b) shows the fixed effect result of conventional banks. The \( R^2 \) is about 76%. It indicates that 76% variations of conventional banks efficiency can be explained by the variations in independent variables which are level of capitalization, liquidity risk, credit risk, riskiness of bank, return on assets and bank size while the remaining of 24% were explained by other factors that are not included in this study. F-statistic describes the overall fitness of the model. The test statistics is F (18.28) with p-value (0.0000) which is less than alpha, \( \alpha (0.05) \), supports the claimed hypothesis which is at least one of the factors which are level of capitalization, liquidity risk, credit risk, riskiness of bank, return on assets and bank size will influence conventional bank efficiency. T-test result shows that there are four variables that have significant p-value less than alpha, \( \alpha (0.05) \) which are level of capitalization, riskiness of bank, return on assets and bank size. It can conclude that level of capitalization, riskiness of bank, return on assets and bank size have significant effect on conventional bank efficiency and thus, \( H_2 \) is accepted.

The following equation model has been generated for this study

\[
\text{Bank Efficiency} = 139.7024 - 0.200262\text{CPT}_1 - 0.005086\text{LR}_2 - 0.036271\text{CR}_3 - 395.0364\text{RB}_4 + 324.9650\text{ROA}_5 - 44.6051\text{BS}_6
\]

4.5 Levene’s Test Analysis

Table 8: Levene’s Test for Equality of Variances

<table>
<thead>
<tr>
<th>Levene’s Test for Equality of Variances</th>
<th>t-test for Equality of Means</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equal variances assumed</td>
<td>Sig. 0.015</td>
</tr>
<tr>
<td>Equal variances not assumed</td>
<td>Sig. (2-tailed) 0.008</td>
</tr>
</tbody>
</table>

Table 8 reveals the result of Levene’s Test for Islamic banks and conventional banks. It shows that sig. value is 0.015 that is less than alpha (\( \alpha = 0.05 \)). Therefore, it indicates that there is difference in variance of efficiency for Islamic banks and conventional banks. The t-statistic for equality of the mean is 0.009, this value is lower than alpha (\( \alpha = 0.05 \)) which indicates that there is significant difference in the efficiency of Islamic banks and conventional banks. Therefore it can conclude that conventional banks are more efficient than Islamic banks. Thus, \( H_3 \) is accepted.

5.0 Conclusion and Recommendation

As a conclusion, the result found from the Hausman Test, is suitable for this study to use Fixed Effect Model to estimate the factors affecting bank efficiency of both types
of banks. The result from Fixed Effect Model shows there are five factors that affect Islamic banks efficiency which are level of capitalization (CPT), credit risk (CR), riskiness of bank (RB), return on asset (ROA) and bank size (BS). For conventional banks, there are four factors that affect the bank efficiency which are level of capitalization (CPT), riskiness of bank (RB), return on asset (ROA) and bank size (BS).

The results are supported by previous studies on factors affecting Islamic banks efficiency. A study by Fakarudin Kamarudin (2016) found that the level of capitalization (CPT) is positively associated with efficiency for Islamic banks and significantly influence the revenue efficiency of domestic Islamic banks operating in Malaysia. A study by Srairi (2013) had found that credit risk (CR) has a significant positive relationship with both performance and efficiency with an indication that the banks’ output mix is favourable to promote efficiency. By that, banks that have a higher number of non-performing loans would be taking more risks and becoming more efficient. Abduh and Alias (2014) while examining the result from Pooled OLS method show that riskiness of bank (RB) is the significant variable affecting the performance of Islamic banks and conventional banks in Malaysia. Previous studies also found that there is a positive association with efficiency on profitability (ROA) of Islamic banks. The finding is consistent with Darrat et al. (2002) who found that profitability is positively associated with technical efficiency. It was also found that the bank size (BS) significantly influences the revenue efficiency of domestic Islamic banks operating in Malaysia, Indonesia and Brunei during the period under research. The result from Wasiuzzaman and Nair (2013) indicated that there is significant differences between the two bank types for bank size.

The result for conventional banks also can be supported by the previous studies on factors that affect bank efficiency. According to Ismail et al. (2013), capitalization (CPT) is positively associated with bank efficiency. This implies that more efficient banks use more equity rather than leverage compared to their peers. This result is in line with Noor and Ahmad, (n.d.) who found a positive relationship between capitalization and bank efficiency levels. Abduh and Alias (2014) examined the result from the study showing that riskiness of bank (RB) is a significant variable affecting the performance of Malaysia Islamic and conventional banks. These studies indicate that both banks do not have much difference in focusing their main business that is providing loan or financing. Return on asset (ROA) is a factor that determines the profit of banks where the results indicate that the more profitable the banks, the more efficient they are (Alrafadi, Yusuf & Kamaruddin, 2015). Ismail et al. (2013) found bank size (BS) for conventional banks to be positively and significantly associated with efficiency. This determines that the larger banks tend to achieve higher efficiency.

Based on the data collected, there is enough evidence to claim that Islamic banks are less efficient than are conventional banks. It can be proven by a previous study, Ismail et al. (2013) that found that conventional banks have been efficient in utilizing information technology and electronics while Islamic banks conversely have been efficient in allocating and utilizing their resources. Other research found that the conventional banks are better than Islamic banks in all efficiency measures. The finding indicates that the conventional banks may be more efficient than the Islamic banks due to managerial efficiency and technological advancement (Ahmad & Abdul Rahman et al., 2012).
On the other hand, the variable that is significant in Islamic banks but not significant in conventional banks is credit risk (CR). The reason that conventional banks are more efficient than Islamic banks can be concluded by the factor that may be significant in determining Islamic banks performance but not necessary significant in affecting the performance of conventional banks. This is due to the different policies and business strategies that are applied in Islamic and conventional banks. In addition, years of operating may be one of the reasons as well since conventional banks started to establish and operate earlier than Islamic Banks.

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Noor, M. A., & Ahmad, N. H. (n.d.). The Determinants of World Islamic Banks ‘ Efficiency : Does Country Income Level have an Impact ?


A Conceptual Framework and Propositions for The Adoption of Islamic Banking Services in India

By

Manzar Ali Khan∗
Nazimah Hussin, Wan Khairuzzaman
Wan Ismail and Jihad Mohammad

Abstract

The aim of this paper is to propose a conceptual framework to study and identify factors that influence the intention to adopt Islamic banking services in India. Islamic banking has evolved as a new reality in the international financial landscape in the recent past. Various studies have been undertaken by researchers to examine issues related to Islamic banking and finance across the world. However, literature revealed the lack of adoption studies on Islamic banking domain. This study employs the decomposed theory of planned behaviour (DTPB) proposed by Taylor and Todd (1995a) to investigate the influence of perceived attributes of intention to adopt Islamic banking services in India. The study also intends to incorporate ethical judgement into DTPB model and investigate its influence on the intention to adopt the Islamic banking services. Further, this study also examines the mediating effect of the ethical judgement on the relationship between the moral obligation, perceived consequences and the intention to adopt Islamic banking services. This study will provide compelling insights into Islamic banking services that will be useful to both banking consumers as well as industry.

Keywords: Islamic banking services, conceptual framework, ethical judgement, India.

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Introduction

The current study aims to develop an improved theoretical framework to identify factors that influence the intention to adopt Islamic banking services. The banking system is considered as the backbone of any country’s economy, and no country can escape from it. The practices of conventional banks are in contrast with Islamic teachings; therefore, devout Muslims needed a banking system that is based on Shariah (known as Islamic teachings). This demand essentially led the foundation of Islamic banking. The term Islamic banking is described as the conduct of banking operations in conformity with Islamic teachings (Mirakhor, 2000). Some of the distinguishing features of Islamic banking operation comprise its prevention of interest-based lending or usury (hereafter riba) and speculation or uncertainty (hereafter gharar). It also gives special attention to religiously permissible (hereafter halal) activity, for instance, perceiving dietary controls on alcohol, tobacco, and pork besides other ethical and religious ends (Warde, 2000). The aim of these merits involve Islam’s concern with building a moral economy, where profits from the business are typically perceived as more favourable in comparison with profits from riba or gharar. The riba and gharar are deliberated as immoral or undesirable due to possible negative social consequences.

The growth of organised consumer activist groups and the increasing availability of ethical products have led to the rise in awareness of consumers which in turn influences their purchasing and consumption behaviour. Ethically determined consumers sense an obligation towards the society and attempt to assert their beliefs by engaging in ethical consumption behaviour (Carrington et al., 2010). This concern led the foundation of socially responsible mutual funds and ethical retail banking. An ethical banking system is one that supports environmentally and socially responsive practices. The Islamic banking system is also considered as one of the forms of ethical banking. The ethical lending with risk sharing is highlighted as being one of the quintessential features of its practice (Walsh, 2007).

Over the last two decades, Islamic banking has emerged as one of the fastest growing industries in the banking sector. The Islamic bank’s assets globally have reached $1.54 trillion with a customer base of 38 million in 2012. It is expected to cross $3.4 trillion by 2018 at an annual growth rate of 17.6% (Ernst and Young, 2014). In spite of this extraordinary growth Islamic banks are experiencing threats from their conventional counterpart. As per Perry and Rehman (2011), the total market share of Islamic banks is only one percent of the total global banking assets. The market share is considered as the robust determinant of bank profitability and growth, which in turn is determined by customer base (Beckett et al., 2000). It is a very well-known fact that the banks are significantly depending upon the deposits from its customers as the main source of its assets. Hence, in order to improve its market share, banks have to increase the number of depositors; to facilitate this it is important to study consumer behaviour. The consumer behavioural study can help in achieving the goals of a bank by identifying the factors responsible for behaviour intention.
Consumer behavioural studies in Islamic banking and finance sphere mostly are related to bank selection criteria (Ramdhony 2013; Saini et al., 2011; Loo, 2010), knowledge dimensions (Khan et al., 2007; Rammal and Zurbruegg 2007), attitudes (Ramdhony 2013; Loo, 2010; Bley and Kuehn, 2004), personal opinions (Loo, 2010; Haque et al., 2009) and preferences (Khan et. al., 2007; Bley and Kuehn, 2004). These dimensions (i.e. knowledge, attitudes, opinions and preferences) display the attitudinal components of cognitive (knowledge), affective (feeling or perception) and conative (intention to use) dimensions (Cyril and Yeo, 2008). However, as per Ajzen (1991), consumer behaviour is guided by the combination of attitude, normative and control beliefs and all these direct to the formation of a behavioural intention which ultimately leads to adoption.

As discussed various researches have been carried out to investigate the issues in the wider context of Islamic banking and finance, whereas, adoption of Islamic banking services in the specific context of India has been rather limited. Therefore, the purpose of this study is to identify the factors that influence consumers’ intention to adopt Islamic banking services. It is crucial to gain a thorough understanding of these factors, so that appropriate strategy can be devised to capture the true potential of this segment.

**Islamic Banking – Indian scenario**

Interestingly, India’s first Islamic finance institute (hereafter IFI) can be traced back from the 1890s. However, these IFI’s were not able to flourish due to various reasons and one of the major causes is the unfavourable banking regulations (Khan and Hussin, 2013). Over the last decade, many significant changes have occurred in the Indian banking sector with a view to raising the efficiency and productivity of banks. With the objective for the banking system to reach more people in India, the Reserve Bank of India (hereafter RBI) had constituted a committee in June 2005 to examine financial instruments used in Islamic Banking headed by Mr Anand Sinha, executive director, RBI. The committee recommended that India has the strong ability to emerge as a potential market for Islamic banking, provided there is a supportive political environment and increased awareness among people in the country. However, the idea was rejected by RBI (Khan and Hussin, 2013).

In 2008, the Planning Commission of India appointed a committee, headed by Raghuram Rajan to recommend different ways to take the country’s financial sector reforms forward. The committee has made two major recommendations: first, measures should be taken to permit the delivery of interest-free finance on a larger scale, through the banking system. Second, it is possible only through appropriate measures to create a framework for such products without any adverse systemic risk impact. The committee report has given a boost to the demand of Islamic banking in India (Khan and Hussin, 2013). The quest to establish Islamic banking in India experienced a break through when RBI gave permission to Cheraman financial services limited, to operate on the basis of Shariah principles (Hindu, 2013).
Furthermore, as per Government of India census 2011 data there are around 180 million Muslim (i.e. 14.2% of the total population) in India, which means that one out of seven persons living in India is a Muslim. This number seems quite enough to establish an Islamic banking system; however, it is ambiguous to articulate. It needs to be explored to which extent the Indians are willing to adopt the Islamic banking services.

**Theory building**

Consumer decision making theories can be grouped into ethical theories and behavioural theories. The Ferrell and Gresham's (1985) contingency framework for understanding ethical decision-making, Rest's (1986) four-stage model of moral judgement, Trevino's (1986) person-situation interactionist model, Hunt and Vitell's (1986) general theory of marketing ethics and Jones' (1991) issue-contingent model, all fall into ethical theories category. On the other hand, the theory of reasoned action (hereafter TRA) (Fishbein and Ajzen, 1975) and the theory of planned behaviour (hereafter TPB) (Ajzen, 1991) are the two base model of behavioural theories. The TPB is the most widely used behavioural theory, with a remarkable history of applications among various domains. One of the desirable features of this model is that it remains fundamentally open to the inclusion of other constructs if they boost its explanatory power (Ajzen, 1991). Modified TPB has been effectively applied to a variety of context-specific applications. The decomposed theory of planned behaviour, (hereafter DTPB) based on the work of Taylor and Todd (1995a) is another successful example of it. This model combines the aspects of the TPB with aspects of Innovation Diffusion Theory (hereafter IDT).

Researchers have been trying to integrate ethical factors in their models based on behavioural theories like the TRA and the TPB; because, these models have ignored the role of non-rational (altruistic) motives in guiding behaviour (Chatzidakis, 2008). In the efforts to study consumer behaviour regarding adoption of different product and services, researchers have identified and examined some factors deliberated as significant in influencing customers’ behaviour when ethics are involved. Among the factors studied includes, perceived unfairness (Fukukawa et al., 2007; Fukukawa, 2002), denial of responsibility (Lee and Kozar, 2008; Harrington, 1996), self-identity (Rise et al., 2013, Hagger and Chatzisarantis, 2006, Shaw and Shiu 2003), moral obligation (Cronan and Al-Rafee, 2008; Goles et al., 2008; Beck and Ajzen, 1991). In summary, most commonly investigated factors are moral obligation and self-identity.

The moral obligation measures, an individual’s internalised ethical rules, which reveal their personal beliefs about right and wrong (Harrison et al., 2005). In the context of ethical consumer decision making, ethical consumers may make ethical consumption choices because ethical issues have become an important part of their self-identity (Shaw et al., 2000). However, according to Hunt and Vitell, (1986) an individual’s ethical
judgements are the function of his or her deontological and teleological moral philosophies.

Although these studies include ethical factors in their model, it is not easy to see the integrated model that fully combines behaviour theory and ethics theory. Therefore, the aim of this study is to propose an integrated model to fully understand the behavioural intention of an individual to adopt Islamic banking services, which combines behavioural theory and ethics theory. To do this, the study will employ the DTPB and normative ethics theories, the two theories most often used in consumer decision making studies, and empirically test the model in India. DTPB is being chosen as a guiding framework for this study since it provides superior expository power and more specific understanding of the antecedents of behaviour by decomposing the attitudinal, normative and control beliefs into multi-dimensional constructs (Taylor and Todd, 1995a).

**Decomposed Theory of Planned Behaviour**

The framework of this study is based on the decomposition process of attitude, subjective norm and perceived behavioural control into multi-dimensional belief constructs based on Taylor and Todd’ (1995a and1995b) work. The arguments and support related to each construct and its decomposed factors are discussed in detail along with hypotheses. The multi-dimensional constructs for attitude in this study primarily are based on Rogers’s (2003) first three attributes of IDT. Various studies (Taylor and Todd, 1995a; 1995b; Bhattacherjee, 2000) have indicated that these attributes consistently influence adoption. These attributes are relative advantage, compatibility and complexity. The remaining two attributes, awareness and uncertainty are based on the work of Echchabi and Aziz (2012).

The subjective norm has been decomposed into interpersonal influence and external influence based on Bhattacherjee (2000) study. Interpersonal influence can be defined as the word of mouth influence from friends, colleagues, superiors, and earlier adopters familiar with the prospective adopters; while, external influence can be defined as the mass media reports, expert opinions, and other non-personal information analysed by adopters in taking a sensible decision (Bhattacherjee, 2000). The PBC has been decomposed into internal control belief and external control belief. The internal control belief is measured by self-efficacy (Taylor and Todd, 1995a and 1995b). While, the external control belief is measured by resource facilitating conditions, a construct related to the availability of resources required to perform a behaviour that was adapted from Taylor and Todd (1995a and 1995b).

We are attempting to extend DTPB by including the ethical judgement as an additional construct into the model. Since the Islamic banking system is being promoted as ethical banking, it is important to know how consumers’ ethical beliefs affect the intention to adopt Islamic banking services. Various studies (Hunt and Vitell, 2006; Yoon, 2011a; 2011b) indicated that the ethical judgements affect an individual’s
behaviour through his or her moral intention. It is believed that ethical judgement should have a significant effect on the intention to adopt Islamic banking services. The ethical judgement construct has been decomposed into multi-dimensional constructs based on previous studies (Hunt and Vitell, 2006; Yoon, 2011a; 2011b) namely, moral obligation and perceived consequences.

**Research Variables**

**Attitude**

Attitude refers to “the degree to which the person has a favourable or unfavourable evaluation or appraisal of the behaviour in question” (Ajzen1991: 188). It is defined by beliefs about the results of performing any behaviour and the apparent significance of that result for the actor (Kiriakidis, 2015). As per Ajzen (1991) intention to perform any behaviour will be greater if the individual has a positive evaluation of performing the behaviour. In other words, the positive attitude with regard to a particular behaviour will direct an individual to a stronger intention to adopt the behaviour. Therefore, if an individual believes that the result of engagement with Islamic banking services is positive, he or she will have a positive attitude to carry out that behaviour. It can be contrary if the outcome of an engagement is negative.

**Proposition 1:** There is a positive relationship between attitude and intention to adopt Islamic banking services.

**Subjective Norm**

Subjective norm refers to “the perceived social pressure to perform or not to perform the behaviour” (Ajzen, 1991: 188). The subjective norm is a combination of normative beliefs and the individual’s motivation to comply with significant others (Fishbein and Ajzen, 1975). An Individual frequently acts depending on his or her perception of what others think they should do, and their intention to adopt the behaviour is potentially influenced by individuals near them. In other words, it is the socially expected mode of conduct. Various studies (Bhattacherjee, 2000; Yoh et al., 2003; Barkhi et al., 2008) revealed a significant relationship between subjective norm and behavioural intention. Lin et al., (2013) found that subjective norm had a direct positive relationship towards willingness to pay for fee-based online music services. We anticipate the similar outcome for intention to adopt the Islamic banking services. A study carried out by Saini et al. (2011) has shown that social factor influences the selection of a bank.

**Proposition 2:** There is a positive relationship between Subjective Norm and intention to adopt Islamic banking services.

**Perceived Behavioural Control**

Perceived behavioural control refers to “the perceived ease or difficulty of performing the behaviour” (Ajzen, 1991: 188). The perceived behavioural control is
Proposition 3: There is a positive relationship between perceived behavioural control and intention to adopt Islamic banking services.

Ethical Judgement

Ethical judgements defined “as an individual’s personal evaluation of the degree to which some behaviour or course of action is ethical or unethical” (Sparks and Pan, 2010). In other words, an individual facing an ethical dilemma evaluates the behaviour, and chooses an ethical or unethical option that best solves the problem in order to achieve the most beneficial results. The general theory of marketing ethics proposed that ethical judgements are determined by both deontological and teleological evaluations when individuals encounter problems with ethical content; in turn, the ethical judgements affect their behavioural intention (Hunt and Vitell, 1986).

Hunt and Vitell’s (1986) model was originally applied to business contexts where it has received considerable empirical support. It has been modified and successfully applied to various other settings. This model implied that ethical judgements affect an individual’s ethical behaviour through his/her ethical intention. Numerous studies have supported the positive influence of ethical judgements on behavioural intentions (Yoon, 2011a, 2011b; Singhapakdi et al. 2013). Yoon (2011a) in his studies on ethical decision making in the digital piracy context suggested that ethical judgement and intention and behaviour are important components of the decision making process.

Proposition 4: There is a positive relationship between perceived behavioural control and intention to adopt Islamic banking services.

Attitude – decomposed

As this study is stressing on attitude towards Islamic banking services, therefore it is essential to recognise belief factors that are influencing the formation of attitude before an attitude is being made. Hence, the proposed conceptual framework integrates salient beliefs and dimensions based on innovation diffusion theory i.e. relative advantage, complexity, compatibility, awareness and uncertainty which may influence individuals’ attitude.

Relative Advantage

Relative advantage is defined as “the degree to which an innovation is perceived as being better than the idea it supersedes” (Rogers, 2003: 229). It aims to depict perception of an individual as to all or some qualities of the proposed product or service can offer incremental value to its prospective adopter comparing with existing options.
al., 2011). In other words, the prospective adopter is interested to know to what extent the proposed innovation is better than the prevailing one. Rogers (2003) ascertain that the adopters acknowledged relative advantage as economic profitability, social prestige, and other potential benefits that would arise out of the adoption of an innovation. Püschel et al., (2010) have extended the relative advantage by incorporating various economic, social, satisfaction and convenience aspects.

The link between relative advantage and attitude has been supported by several scholars in their work. Teo and Pok (2003) investigated the WAP-enabled mobile phone adoption and have found a significant relationship between relative advantage and attitude. This research proposes to examine the economic benefits (profits earnings, low initial cost and incentives), convenience and efficiency of Islamic banks, within the parameter of relative advantage.

**Proposition 1a: There is a positive relationship between relative advantage and attitude.**

**Complexity**

Complexity is “the degree to which an innovation is perceived as relatively difficult to understand and use” (Rogers, 2003: 15). In other words, if the potential adopter perceives a new product or service as difficult to understand or use, it is less likely he or she will adopt it. Complexity is negatively related to the adoption rate of a product or service, owing to the fact that intricacy of new product or service can act as a hurdle for its implementation in an effective manner (Corrigan, 2012; Wang et al., 2010). Studies have recognised that complexity is negatively related to attitude. In a study, Tan and Teo (2000) established that complexity negatively influenced the attitude toward adopting Internet banking. The complexities of Islamic banking contracts, transaction structure and layering of products makes Islamic banking adoption complex. Hence, it is important to investigate the complexity of Islamic banking services and its possible impact on adoption.

**Proposition 1b: There is a negative relationship between complexity and attitude.**

**Compatibility**

Compatibility is “the degree to which an innovation is perceived as consistent with the existing values, past experiences, and needs of potential adopters” (Rogers, 2003: 15). In other words, it is the extent to which a new product or service is compatible with the needs, belief, values, experiences, habits, skills and work practices of the prospective adopter (Harrington and Ruppel, 1999). As per Rogers (2003), the individual is likely to align himself with ideas that are in line with his or her interests, needs and existing attitudes. Studies have revealed a positive relationship between compatibility and
attitude. Tan and Teo (2000), in a study on adoption of Internet banking, indicated that users who feel Internet banking as compatible to their values developed a positive attitude towards it. In this research compatibility is a concern with the extent to which Islamic banking services suit the individual’s banking needs, belief, values, experience and habits.

**Proposition 1c: There is a positive relationship between compatibility and attitude.**

**Awareness**

Awareness can be defined as the individual’s passive involvement and increased interest towards certain issues (Choi et al., 2008). It is the degree to which an individual has the knowledge of the innovation’s existence, and does this knowledge motivate him to learn more about the innovation. An individual undergoes a course of knowledge, persuasion, assessment and confirmation prior to adopting an innovation (Rogers, 2003). The positive influence of awareness on attitude has been supported by various studies. Wu and Lo (2009) in a study on the consumers’ purchase intention towards the extended product found that awareness has a significant influence on attitude. Similarly, To et al. (2007) in their study on adoption of Instant Messaging (IM) in organisations found that awareness has a positive significant effect on attitude. Therefore, it is assumed that enhanced knowledge of Islamic banking products, contracts and terminologies would positively influence individual’s attitude.

**Proposition 1d: There is a positive relationship between awareness and attitude.**

**Uncertainty**

As per Rogers (2003) uncertainty is an important obstacle to the adoption of innovations, as innovation’s consequences create uncertainty. These “consequences are the changes that occur in an individual or a social system as a result of the adoption or rejection of an innovation” (Rogers, 2003: 436). As per Rogers (2003) the more an individual feels uncertain about an innovation, the lower would be the rate of adoption. In order to decrease the uncertainty, individual try to gain more information to make them aware of all its consequences. A trialable innovation relatively creates less uncertainty to an individual who is anticipating the adoption of the same, since it is possible to learn by testing (Rogers, 2003). In fact, with the Islamic banking services trial before the adoption is not possible; it may form further uncertainty in the mind of a potential adopter. Therefore, it is believed that there is a negative relationship between uncertainty and attitude. The confusion, fear, risk, trust and doubtfulness about innovation are identified as some of the elements of uncertainty (Rogers, 2003).
**Proposition 1e:** There is a negative relationship between uncertainty and attitude.

**Subjective Norm – decomposed**

A range of studies has identified some reference groups who may apply social pressure on individuals to perform a certain behaviour. Taylor and Todd (1995a) found that peers and superiors exert a significant effect on individuals of using computers at computing resource centre. However, Bhattacherjee (2000) in his study has prevailed over this restraint by enlarging the scale of subjective norm construct by dividing it into interpersonal (normative) and external (informational) influences. He observed that external influence is as important as an interpersonal influence in individual formation of the subjective norm.

**Interpersonal influence**

The Interpersonal influence refers to word-of-mouth influence by the perception of some important references (i.e., family, friends, peers or superiors etc.) regarding his/her behaviour (Bhattacherjee, 2000). The intention of conducting a certain behaviour is strong when performing that behaviour is encouraged by the surrounding people (Bhattacherjee, 2000; Hung and Chang 2005; Lin et al., 2013). It is believed that if social beliefs support Islamic banking services it is more likely that individual will adopt Islamic banking services.

**Proposition 2a:** There is a positive relationship between interpersonal influence and subjective norm.

**External influence**

The external influence refers to informational encouragement from the external environment (e.g., mass media reports, expert opinions, government policies, and other non-personal information) which motivate individuals to perform the behaviour (Bhattacherjee, 2000). For instance, the intention to adopt Islamic banking services may be higher after watching TV commercials, reviewing advertising flyers, and attending exhibitions or workshops hosted by the government or companies (Bhattacherjee, 2000; Hung and Chang 2005; Lin et al., 2013).

**Proposition 2b:** There is a positive relationship between external influence and subjective norm.

**Perceived Behavioural Control - decomposed**

The perceived behavioural control reflects the access to the internal and external constraints that may affect an individual’s performance. The internal constraints of behavioural control are measured by self-efficacy, while external constraints of behavioural control are measured by facilitating conditions.
Self-Efficacy

Self-efficacy is concerned with the individual’s confidence in performing the behaviour (Lin, 2007). It is an individual judgement of his or her abilities to manage and carry out procedures needed to achieve required performances. It is concerned not with the skills an individual possess but with the judgements of what an individual can do with whatever skills he or she possesses (Bandura, 1986). This narrative determines the significance of differentiating among the skills and ability to manage and carry out procedures. In Islamic banking context, self-efficacy refers to the individual’s self-assessments of his or her capabilities to carry out a transaction in Islamic banking services.

Proposition 3a: There is a positive relationship between self-efficacy and perceived behaviour control.

Facilitating Conditions

Facilitating conditions is concerned with the beliefs regarding the availability of resources that are required to carry out the behaviour (Lin, 2007). This might include access to resources such as the time, money and opportunity. In Islamic banking context, apart from time, money, and opportunity, government support is one of the essential resources. The government support is vital because the Islamic banking system is relatively new in comparison to its conventional counterpart.

Proposition 3b: There is a positive relationship between facilitating conditions and perceived behaviour control.

Ethical Judgement–decomposed

The HV model proposes that decision makers reach ethical judgements by way of two distinct paths. The first utilises deontological evaluations which occur as decision makers employ laws, rules, codes or behavioural norms to each perceived alternative. While the second path is teleological evaluation which considers the possible consequences produced by a given perceived alternative. The teleology evaluation postulates that an action is ethically correct if it produces a net balance of good over evil for the decision maker or society as a whole (Hunt and Vitell, 2006). Several studies have documented the deontological and teleological influence on ethical judgement (DeConinek, and Lewis 1997; Hunt and Vitell, 2006; Cherry and Fraedrick, 2002). Hence, the following two components: a moral obligation (i.e. deontological evaluations) and perceived consequences (teleological evaluations), the researcher believes that can be used to decompose the ethical judgement construct.

Moral Obligation

Moral obligation is a deontological concept that refers to the feeling of guilt or the personal obligation to perform or not to perform the behaviour. (Cronan and Al-Rafee,
2008). It is a Kantian concept that holds that acts are inherently right or wrong, irrespective of the consequences of the acts. The central theme of deontological evaluations is that people have duties or obligations to do those things that are inherently right (Keller et al., 2015). In other words, an individual has a duty or obligation to take the right action. For example, to pay debts, care for children, or tell the truth is an individual duty because it is the ‘right’ thing to do. Therefore, to make the correct ethical choices, an individual has to understand what his duties are and what correct rules are available which regulate those duties (Reidenbach and Robin, 1990).

In a nutshell, moral obligation is the personal obligation that an individual has in order to perform or not perform an action. When faced with ethical dilemmas, an individual who uses moral obligation is expected to be more likely to form ethical judgements. They would form judgements based on motivation and duty that adhere to rules and regulations. Several studies have been carried out to investigate the influence of deontology on ethical judgements indicating a positive significant relationship (DeConinck, and Lewis 1997; Hunt and Vitell, 2006; Cherry and Fraedrich, 2002).

Proposition 4a: There is a positive relationship between moral obligation and ethical judgement.

Perceived Consequences

The term perceived consequence as used in this study refers to teleological evaluations. It can be defined as “the relative amount of goodness or badness of the consequences of a behaviour that determines its, rightness or wrongness” (Hunt and Vasquez-Parraga, 1993: 78). Based on this proposition, perceived consequences can be defined as the correct actions to be taken in any given situation and are the ones which resulted in the greatest number of positive consequences, relative to any negative consequences. In other words, the choice that yields the greatest benefit to most people is the one that is ethically correct (Reidenbach and Robin, 1990). When faced with an ethical dilemma, the individuals who evaluate problems based on perceived consequences are expected to be more likely to form ethical judgements. These people would form ethical judgements after evaluating the actions, with respect to the net goodness or badness of the consequences it effectuates. The ethical judgement is considered ethical if it could provide the maximum happiness to the majority of the stakeholders (Zakaria and Lajis, 2012). Prior studies have investigated the influence of teleology on ethical judgements and indicate a positive strong relationship (DeConinck, and Lewis 1997; Hunt and Vitell, 2006; Cherry and Fraedrich, 2002).

Proposition 4b: There is a positive relationship between perceived consequences and ethical judgement.

Conceptual Model

The conceptual model (Figure 1) derived from propositions provide the basis for the study to be conducted. The conceptual model is based on decomposed theory of
planned behaviour proposed by Taylor and Todd (1995a and 1995b). The model aims to explain, how the attributes of innovation determine the attitude towards adoption of Islamic banking services. In addition, it also aims to explain how the ethical judgement influences the intention to adopt Islamic banking services, as well as to explain the relationship between ethical judgement and its antecedents.

**Conclusion**

This concept paper proposes a framework for the study of intention to adopt Islamic banking services in India. Based on the broad literature review in the areas of Islamic Banking, together with the evaluation of the suitability of applying DTPB, this study proposes the integration of ethical judgements in the DTPB model and sets to test its influence as both independent and mediating variable amongst the moral obligation, and perceived consequences. It is expected that the outcome would be of immense importance to the practitioners and other relevant stakeholders would emerge when the framework is validated.

*Figure 1: Conceptual Model for Islamic Banking Services Adoption*
References


Putting Social Justice First: The Case of Islamic Economics

By
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Abstract

If we try to figure out the most pressing economic problems in the world today, most concerned citizens would prioritize those problems related to urgent societal welfare needs—e.g., feeding the hungry, housing the homeless, and treating the sick or disabled. But we find a huge mismatch between these objectives and the intents, priorities, and effects of modern economic systems, which are fixated on increasing wealth and production often at the cost of other factors that relate to human welfare. In this paper, we argue the case for a new economics in which social justice acts as the cornerstone. Towards this vision, we present the case of Islamic economics, which is an economic system based on justice, equality, and other principles that prohibit exploitation of others and social harm.

Key-words: Hunger; Justice; Islam; Development; Islamic Economics

1 The Problem of Social Injustice

The problem of hunger

“Earth provides enough to satisfy every man’s need, but not any man’s greed.”—Gandhi

Food is a fundamental human need and the sine qua non of human development. Malnutrition—owing to hunger due to the lack of food or limited availability; and the poor nutritious quality of food—leads to problems such as poor cognitive growth and disease susceptibility, which lead in the long term to higher health costs as well as lost growth opportunities. Seen this way, feeding the hungry becomes—in addition to being an ethical, welfare, human rights or social protection issue—also an all-important economics issue. The desire to eliminate absolute poverty has recently seen increasing interest

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amongst humanitarians and United Nations (UN) has specified the elimination of absolute poverty as one of the Millennium Development Goals (MDG) and the Sustainable Development Goals (SDG).

Despite the significant lack of attention to the problem of hunger by mainstream economists, the problem of hunger naturally arises as arguably the first fundamental economic problem of humanity (Zaman, A., 2015). The importance of feeding the poor can be gauged from the fact that the Copenhagen Consensus project\(^1\)—which ranks potential development investments according to the probable return on investment based on feedback from top economists—has ranked nutritional interventions as the highest of the 17 potential development investments suggested. In other words, better nutrition was deemed by these experts to be the best way to spend a dollar to do “good” in the world (so much so that every dollar invested in micronutrients provides a 59-fold payoff).

Unfortunately, we are far from finding a solution to the problem of hunger. Despite the great technological progress (including in food production), modern world is still characterized by the embarrassing juxtaposition of great abundance and dire poverty. Approximately one in nine people on earth (some 800 million people) go to bed hungry—the vast majority of these people live in developing countries, where 12.9 percent of the population is undernourished\(^2\). True to the Gandhian wisdom, there is substantial data that indicated that the primary problem of hunger is not the lack of food supplies but that of entitlement (Sen, 1983). Poverty and hunger prevail because of economics, not scarcity. In capitalistic societies, a man is considered entitled to only that what he can earn; in an inconvenient situation where jobs are not available, a man may starve even in the midst of plentiful food supply since the poor man does not have entitlement to food. As argued in Zaman (2012S), the problem of scarcity is created by ideological and normative biases of modern economic theories, and not by the objective realities of the world around us.

The problem of inequality

“The imbalance between the rich and the poor is the oldest and most fatal ailment of all republics”, Plutarch.

There are multiple types of inequality at play in modern societies: economic, political, and opportunistic. As noted in (Atkinson, A.B., 2015), inequality can refer to inequities in income, wealth, health, opportunities, access to justice, and exposure to hazards. Unfortunately, inequality levels have been rising in most parts of the world. Take the case of America, where the upper 1 percent of Americans takes in nearly a quarter of the annual national income. In terms of wealth, the distribution is even more lopsided with the top 1 percent controlling 40 percent of wealth. While inequality has always existed in human societies at one scale or the other, the modern level of inequalities is reaching dangerous proportions.

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\(^1\) [www.copenhagenconsensus.com/](http://www.copenhagenconsensus.com/)

\(^2\) Source: World Food Programme (WFP.org); Food and Agriculture Organization of the United Nations (FAO);
US President Obama has identified the reduction of income inequality and helping of income mobility as “the defining challenge of our time”. To be sure, inequality is preventable if we are seriously interested. To show this concretely, we refer to the study of ethicist Peter Singer (Singer, P., 2011) who made a point that the UN millennium goals could have been met in the US—remarkably without involving any contribution from the US government, any non-U.S. citizen, or any U.S. citizen from the bottom 99.9% of our population—by only redistributing the excess money of the top 0.01% to the poor, while still leaving each household of the top .01% a decent share for their households. Thus inequality is not inevitable if we were resolute enough to also consider parting with economical and political orthodoxy and developing a new economics based on concerns for social justice. Here again, modern economic theory creates a major obstacle, because it pretends to be a positive discipline which is value free. In fact, modern economic theories are in violent conflict with demands of social justice, and provide strong normative arguments for accepting and perpetuating increasing inequalities. What makes these theories more dangerous is their claim to being a scientific and objective description of facts; Zaman (2012S) brings out the hidden normative foundation on which these apparently positive theories are constructed.

The Cost of Inequality and the Benefits of an Egalitarian Society:

Inequality acts as a vicious cycle: inequality breeds further inequality as the powerful strata rig the various social systems through politics in a way that exacerbates the conditions of the poor, while favoring the rich and powerful and giving them an unacceptable control over the lives of the poor. This is referred to as the “dance of ideology and unequal riches” (McCarty et al. 2016.)

Apart from the moral case for a fairer and more equal society, for the sake of fairness of opportunity and well being, there is a strong economic case since inequality hinders growth (as the lack of opportunities for the underprivileged means that the human resources are not tapped into fully). There is instrumental value in the reduction of inequality. As demonstrated by Stiglitz (Stiglitz, J.E., 2012) and Atkinson (Atkinson, A.B., 2015), inequality leads to a slew of social problems such as lack of social cohesion, increased crime, poor health, etc. and unequal countries tend to perform worse in terms of infant mortality, teenage births, educational performance, homicide and imprisonment, life expectancy, mental illness and obesity.

2 Why Modern Economics Has Perpetuated Great Inequality? Wrong Ideals and Priorities

In this section, we discuss the three main reasons why modern economics has perpetuated great inequality.

2A – Focus on Production Rather Than Welfare

The dominant economics school of thought—essentially the neoclassical school—has posited a widely accepted belief that the goal of the economic system is the

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production of wealth. This emphasis on production rather than well-being is flawed. If there was a perfect correlation between economic prosperity and human welfare, one may have condoned the pursuit of economic prosperity as an end rather than as a means as flawed in principle but practically useful nonetheless. But as highlighted by Amartya Sen (Sen, 2003), there is no such perfect correlation. In fact, it is commonplace to see countries with very high GNP per capita in which the bulk of the population has a dismal quality of life (with problems such as overwhelming illiteracy, escapable morbidity, etc.).

This is especially true in modern capitalistic societies in which an unbridled focus on production is breeding inequality due to the tendency of capitalistic systems to concentrate wealth. The resulting unequal distribution of wealth leads to social and economic instability. Piketty, T. and Ganser, L.J., 2014 have shown that the return on capital \( r \) is generally higher than economic growth \( g \), and this tendency \( r > g \) results in much more concentration of wealth, resulting in increasingly less equitable wealth distribution over time. It is widely believed that in capitalism, inequality is not given its due attention due to its single-minded focus on the primacy of economic growth. One reason behind this lack of attention is the belief that inequality is not only an artifact of capitalism but also an engine for its growth. This leads to the perverse conclusion that lowering inequality is not desirable since it may lower the rate of growth.

**2B – Incorrect Causal Reasoning**

According to the theory of “paradigm shift” proposed by the American philosopher Thomas Kuhn, data is not interpreted neutrally but according to the currently prevailing worldview of the basic concepts of a scientific discipline. Currently, the dominant accepted economics worldview is based on capitalism and many of the current economic models promote a capitalism-friendly misunderstanding of the causality of economic effects. Some common backward thinking is presented.

1. **Making More Money Leads to Poverty Elimination Or Vice Versa**

   "Wealth does not bring goodness, but goodness brings wealth and every other blessing, both to the individual and to the state."—Socrates

   Available evidence shows that material advance on its own is insufficient to increase happiness and social harmony. For instance, it has been shown that average happiness scores do not rise (or rise slowly) despite considerable growth in living standards. This paradoxical insight was first noted by Easterlin (and is thus called Easterlin’s Paradox) who performed multiple surveys in 19 developed and developing countries to conclude that rich countries are not typically happier than poor countries. The general assumption in mainstream economics is that accumulation of wealth and spending on one’s self and consuming desired things makes a person happy. Researchers are realizing now that welfare and happiness depends mostly on noneconomic variables (such as social “capital” or relationships) not considered by economic theory. It has been shown that it is spending on others—rather than on one’s own self—that brings the greatest happiness (Dunn, E. and Norton, M., 2014). Researchers are also now discrediting the hypothesis that success leads to happiness to an improved hypothesis that shows this effect more potently in the reverse, i.e., happiness leads to success (Anchor, S., 2010).
2. Does Economic Growth—Even if Achieved Exploitatively—Pay In the Long-Run?

“We were taught to take care of our GNP because it would take care of poverty. Let us reverse this and take care of poverty because it will take care of the GNP”—Mahbub ul Haq

The influential economics hypothesis known as the Kuznet’s hypothesis, which posits that as a country develops economically, inequality first increases and then decreases. This hypothesis has strongly influenced the way in which inequality has been studied and understood over the last half century. This hypothesis has been used to support the “trickle-down effect”, which justifies the exploitation of human labor in the short-term hoping that the long-term benefits of increased economic production will eventually trickle down to the poor. Curiously, the trickle-down theory (based on the commonly-held belief of supply-side economics) is built on a strange motivation theory that posits that rich will work harder at investing if they are made richer, but the poor should be made poorer to make them work harder.

This essence of the “trickle down effect” theory that we are free to exploit and expend human capital; doing so will allow us to make more wealth, which in the long run translates to more happiness and less unfulfilled needs for all. Experience has shown that the “trickle-down effect” fails to materialize (Chang, H.J., 2012). A better name for the empirically observed effect could be the “vacuum cleaner effect” since the “wealth is sucked up from the poor and concentrates in the loot bags of the rich”.

2C - The marginalization of morality, virtue, religion, and ethics

Logical positivism was a 20th century movement that aimed to eliminate subjective statements from social science and instead relying only on empirical data and logic. In line with the time’s zeitgeist, economists and social scientists started to marginalize the considerations of virtue, values, and ethical values. Instead of building a normative science that incorporates and engenders desirable virtues of fairness, justice, altruism and generosity, an economics based on the abstraction of a self-interested rational utilitarian homo economicus was constructed. Discussions on justice, fairness, concentration of wealth and power became increasingly less important as they were thought to be ‘unscientific’ and thus not a part of social science (Tawney, 1926). There was a rapid shift in which the Europeans went from believing in the Biblical “Love of money is the root of all evil,” to Shaw’s “Lack of money is the root of all evil.”

The marginalization of morality, virtue, religion, and ethics has resulted in an economics without telos. By stripping economics from its teleology, there is a crisis of meaning and a grand confusion between the means and the ends of economics. Just like in technological healthcare where the emphasis is now on diagnostic accuracy and technical performance (leading to overtreatment) rather than on well-being and health, the purpose of economics has become increasing wealth for its own rather than understanding attaining human welfare as the purpose of economics. There is also a concern that the market systems are not appropriate for many aspects of human lives due to various concerns of justice, fair play, and ethical conduct (Sandel, M.J., 2010).

Keynes summarized the attitude of neoclassical economics school when he said that for acquiring wealth, it was temporarily necessary to “pretend that fair is foul, and foul is fair” for “foul is useful, and fair is not.” It was assumed that man could pursue wealth using avarice and greed, and when the economic problem of scarcity is solved, man could turn to a moral life. However, experience has shown capitalism brings forward a ruthless economy in which greed engenders only more greed rather than morality.

3 Economics As If Social Justice Mattered

“Justice is the first virtue of social institutions, as truth is of systems of thought.”—Rawls.

3A Human Development: An End in Itself

“So act as to treat humanity, whether in thine own person or in that of any other, in every case as an end withal, never as means only.”—Immanuel Kant in his Grundlegung zur Metaphysik de Sitten

The Pakistani economist Mahbub ul Haq who invented the Human Development Index (HDI) noticed the fallacy of orthodox economic thought that believes economic development to be an end goal. He was brave enough to admit (after toiling for years chasing the “trickle down” chimera) that, "After many decades of development, we are rediscovering the obvious—that people are both the means and the end of economic development".

Human beings have a dual role in development—firstly, they are an agent of development in that they are directly or indirectly the primary means of all production; secondly; they are end beneficiaries of all progress (Sen, 2003). This dual role has been a constant source of misdirected goals since it is easy to fall back into the flawed thinking model in which people are viewed as the means to obtaining productive progress (rather than as seeing human lives as the ultimate concern, and relegating production and economic growth as mere means to those ends). Unfortunately, this all-important distinction has been overlooked in orthodox economics to grave consequences.

The World Bank (2006) report asserts that development is the process of transforming tangible resources into intangibles like human, institutional and social capital. In complete contrast, modern economics is based on the production function which transforms precious human lives (labor) into tangible wealth. The overbearing focus on economic growth has relegated the value of human life, which is now evaluated in terms of how much wealth the human can produce.

3B Return to Virtue/Morality: Seeking Just Societies

"Economics is essentially a moral science”—Keynes

In modern moral philosophy, there are three dominant ideas relating to justice: maximizing welfare; respecting freedom; and promoting virtue. The predominant theory that follows from neoclassical economic systems well entrenched in modern capitalistic society is (some form of) utilitarianism. We argue that to design just societies, we need to reemphasize a virtue-based system that actively promotes justice.
Unfortunately, the materialist and wealth focused aim of capitalistic economic systems has turned the traditional notions of virtue and vice upside down. The goal of pursuit of wealth—considered all-important in capitalistic societies—has been frowned upon universally in almost all traditional cultures, except in our own modern culture. Islam discourages excessive love and pursuit of wealth beyond a person’s basic needs. The promotion of greed as a virtue in capitalistic societies is also in stark contrast with the Christian tradition, which says, “the love of wealth is the root of all evil.” The reversal of traditional values and the undermining of concepts of justice from morality and tradition have led to societies in which some enjoy opulence and wanton luxury while others are even denied basic amenities of life such as food, housing, and health services.

To a large extent, economists in their pursuit for more and more wealth have largely ignored concerns of fairness, ethics, and justice. The American political philosopher John Rawls argued that the distribution of income and wealth that results from a free market with formal equality of opportunity couldn’t be considered just. To fairly design such a system, Rawls offers that the distribution mechanisms should be designed under “veil of ignorance” in which no person knows his place in society, his class position or social status a priori. Under such settings, it is clear to see that capitalism is not a just system due to the little attention it gives to distribution of resources especially to the downtrodden. Rawls accommodated for some social and economic inequality by considering the “difference principle” under which some people in society may have more wealth, income, or power—but only on the basis that these inequalities work to the benefit of the least advantaged members of society and that the social positions are open for all.

3C Distribution and Quality of Life Aware Economics

The grave lack of focus and indifference to distribution-related issues can be noted in comments of the Nobel Prize-winning economist Robert Lucas, who said that “Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution.... The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production.”

Notwithstanding the positive role that economic growth can play in improving the lives of the poor, it is important to emphasize that the distribution of income also has profound effects on the functioning of society and the well being of individuals. The lack of attention paid to distributional issues by mainstream economists is a major reason for exacerbating levels of inequality. Given the state of high inequality in many countries, many economists are now promoting the use of appropriate redistribution mechanisms (Chang, H.J., 2014). (Atkinson, A.B., 2015).

Mahbub ul Haq noted, it is the case in many societies that “GNP can increase while human lives shrivel”. Many measurements of development can report good results even in “perfectly disgusting” conditions. Consider the point made by Amartya Sen—the 1998 Nobel Prize winner—regarding how an economy can be “optimal” in the Pareto sense even when some people are rolling in luxury and others are near starvation, if the
starvers cannot be made better off without cutting into the pleasures of the rich. Amartya Sen underscored his point by saying that “In short, a society or an economy can be Pareto-optimal and still be perfectly disgusting.”

The diversity of individual profiles embedded in a distribution is often camouflaged by the use of measurement indices (such as averages) that are reductionist and suppress information regarding the variation in the distribution. For example, it is possible for a rise in average income to be shared unequally across groups, leaving some households relatively worse-off than others. In such cases, the median values can be a better indicator of the “typical” individual or household. Also, for studies of justice and fairness, we are usually more interested in what is happening at the bottom of the distribution rather than at the middle or at the top.

4 The Case of Islamic Economics

In this section, we present the case of Islamic economics as a justice-based socially equitable economic system. While we aim to provide a self-contained introduction to the salient points of Islamic economics, our treatment of this vast topic is incomplete. For a more detailed exposition written for a western audience, we refer interested readers to (Zaman, 2008).

4 A Islamic Economics and Its Goals

Prophet Muhammad, peace be upon him (pbuh) said, “When a nation abandons justice and fairness in its affairs, failure and destruction becomes imminent for it.”

The primary objective of an Islamic economic system—and its defining characteristic—is the imperative to establish economic justice. It is stated in the Quran that the purpose of sending divine messengers to different people is to establish humankind on justice (Quran, 57:25). Modern western economic system—in particular, the capitalistic system—has the acquisition and multiplication of wealth as its prime objective. This makes the end of Islamic economics and western economics markedly distinct (Zaman, A., 2008) (Zaman, A., 2012).

The Goals of Shariah: Objectives (Maqaṣid and Human Good (Maslahat)

Islamic law (Shariah) provides the framework for all activity within an Islamic society. The famous Islamic theologian Al-Ghazali described the very objective of the Shariah is to promote the welfare of the people (Maslahat). Al-Ghazali summarized human welfare in safeguarding of five things: (1) their faith; (2) their life; (3) their intellect; (4) their posterity; (5) and their wealth. Anything that safeguards these five things is said to serve public interest and is desirable from the point of view of Shariah.

Islamic law has underlying objectives called Maqaṣid, which refer to the divine intents and moral concepts—such as justice, facilitation, social cooperation, human dignity, magnanimity, chastity, and compassion—underlying actions prescribed in Islamic law (Chapra et al. 2008) (Auda, J., 2008). Islamic economics also falls under the rubric of Shariah and thus is bound by its goal and purpose. Imam Al-Shatibi, the great Andalusi scholar who was an authority on the science of Maqaṣid, elaborated on the
objectives of *Shariah* by saying, “*Shariah* stands for justice, mercy, wisdom, and good. Thus, any ruling that replaces justice with injustice, mercy with its opposite, common good with mischief, or wisdom with nonsense, is a ruling that does not belong to the *Shariah*, even if it is claimed to be so according to some interpretation.” (cited in Auda, J., 2008).

In the Islamic tradition, wealth is understood in a purely instrumental capacity. In Islamic worldview, human development is not the same as accumulation of wealth (Zaman, A., 2013). According to a Prophetic Hadith, wealth is said to be the contentment of the heart. A central concept in Islam that wealth should be used to pursue the *Akhirah* (by doing things that will please God) and not for idle purposes. Acquisition of wealth is permissible only in ways that are just to all the parties concerned. Islamic law prohibits exploitation, arbitrary taxation, and any action that leads to social harm. This puts numerous restrictions on profit-based business practices that can otherwise lead to social inequitable outcomes.

The Indian theologian Shah Waliullah (Waliullah, S., 1750) anticipated the modern welfare state and described how it is the birth right of every human being in an Islamic state to have access to bread, clothes, house, the right to marry, and education and nourishment for his children without any discrimination of caste and creed. Furthermore, every citizen of the Islamic state also has an equal right to justice, security of life and property, protection of honor, freedom.

4B Emphasizing Redistribution

“*Make sure that wealth should not be confined among those of you who are affluent.*” (Quran, 59:7)

Islamic thought emphasizes human brotherhood in which a person’s value is based on that person’s *Taqwa* or God-consciousness, and not according to the amount of wealth or power that person possesses. The unflinching commitment to human brotherhood is reflected in the Islamic economic system’s inviolable goal of socio-economic justice, which in turn requires equitable distribution of wealth and the fulfillment of basic human needs of all people.

According to Islamic thought, any business and trade that confines the circulation of wealth in any particular class of people is ruinous for that society since this will lead to the accumulation of wealth by a minor fraction of the society and the effective enslaving of the poor. This is one of the reasons behind the strict restrictions on interest-based transactions in Islamic law (Quran, 2:278-279).

A simple redistribution of excess consumption towards the fulfillment of the basic needs of the poor can itself do wonders for human welfare. Studies of happiness have shown that wasteful and ostentatious consumption does not even bring happiness to the consumer. Preventing wasteful consumption, as per Islamic teachings, would lead to a

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5 *Akhirah* refers to concept of an afterlife, an important part of Islamic eschatology, in which humans will be resurrected and will be recompensed justly according to their actions in this world.
happier and healthier society, and also enable resources to be directed towards more beneficial social purposes.

**Distinguishing between Needs and Wants**

“By no means shall ye attain righteousness unless ye give (freely) of that which ye love.” (Quran 3:92)

The needs of human beings are limited even though the desires are limitless. This need and want distinction is extremely important for sustainable human welfare since there is a real chance of the excessive desires of one person impinging on the due rights of other members of the society. It is surprising to see the little attention paid to this needs/wants distinction in the mainstream Western economics textbooks. The needs/wants distinction finds support from the utilitarian school of ethics, which describes justice as the greater good of all. However, such thinking is very much at the fringes of economics orthodoxy and rarely informs the concerns of modern economics.

An extremely important ingredient of the message of Islam is to spend wealth in excess of our needs on others. The basic principle in Islam is to focus on the needs but to avoid wastage and going to excess (Zaman, A., 2010). In contrast to the conventional worldview, the ideal amount of wealth for a person according to the Islamic worldview is that what is just sufficient for our needs, and it stated that both wealth and poverty are trials from God (Q89: 15-16). Accordingly, Islam discourages the irrational pursuit of wealth for its own sake, and instead encourages charity and spending on others. This is a very different attitude towards wealth distinct from the attitude implicit in economic theories and assumed in capitalist economies.

**4C Transformative Moral Guidance: The Imperative to Establish Justice**

“Whosoever of you sees an evil, let him change it with his hand; and if he is not able to do so, then [let him change it] with his tongue; and if he is not able to do so, then with his heart—and that is the weakest of faith.” (Arbaeen Nawawi, Hadith 34).

In the economic domain, Islamic law regulates both methods by which money may be earned and also the ways it may be spent. A promising—yet largely ignored—approach to address the problems of widespread hunger and poverty is to encourage altruism and generosity instead of condoning greed by setting it up as the normative “natural” position. Islamic economics is transformative in the sense that Islamic economists do not seek only to study the world but also to change it. To incentivize people to act according to these lofty standards, the Islamic value system praises humane qualities of generosity, empathy, altruism and sacrifice.

The Islamic economics approach to scarcity is markedly different from that of classical economics solution, which deals with scarcity by pushing the producer to increase production; the Islamic economics approach is that we should spend generously on others less fortunate than us and restrict our desires instead of always striving for more wealth. The act of spending in the path of God is known as *Infaq fi Sabilillah* and is one of the highest virtues in Islam. Islam not only encourages the spending of money by the
rich on the poor, but it has also stipulated that the poor has a right on the rich. A rich person has to spend a minimum of 2.5% of his wealth annually on the poor and pay the Zakah (obligatory charity). There is repeated exhortation in Islamic scriptures regarding Infaq: e.g., a Hadith of the Prophet Muhammad (pbuh) says, “The creatures are all dependent on Allah, and the most beloved by Him are those who are most beneficial to His dependents.” The Islamic approach recommends generosity and presents a system in which even the poor can give charity (even if it is little).

In recent times, ethicist such as Peter Singer, and movements such as effective altruism, have worked on mobilizing people to give money in charity to people, arguing that it is morally indefensible for the rich not to spend on the poor many of whom are dying because of trivial preventable diseases. However, such a movement lacks the communal motivation and the sense of brotherhood and telos that binds together the followers of Islam, a religion of more than 1.6 billion people worldwide.

5 Conclusions

The modern economic system makes a grave mistake of confusing generating wealth—which is only an instrumental tool useful for increasing human welfare—as the end goal of economics. We believe that human welfare is both the mean and the end of human development. Accordingly, the fundamental economic problem is to study how to use a given amount of wealth to produce the maximum amount of welfare.

In its bid to become neutral, “value-free”, and scientific, the western economic system has lost its focus on notions of social justice and fairness. Despite its attempt to be value-free, modern economics espouses many criteria that are value-laden. Taking into account its great influence, the field of economics should become much more aware of the values it implicitly or explicitly endorses. In particular, economics should try to incorporate desirable values such as honesty, honor, respect, fairness, and egalitarianism.

This goal is not new—although new economics seldom thinks about these issues—and thinkers from at least the time of Aristotle have voiced similar positions.

In this paper, we present the case of Islamic economics as a viable justice-based solution to the modern economic problems of inequality and hunger. The Islamic economic system does not consider accumulation of wealth to be human development and considers the establishment of justice as its end goal. Islamic economics emphasizes equality and brotherhood of all humanity, and has a spiritual incentive system and a transformative attitude towards engendering positive values in societies and individuals. Islamic economics also makes a distinction between needs and desires—the Islamic ethos is based on suppressing desire for worldly luxuries and on sharing the superfluous wealth with the poor and needy through charity.

References:


Chang, H.J., 2012. 23 things they don't tell you about capitalism. Bloomsbury Publishing USA.


Book Review

Title: Predictably Irrational.
Author: Dan Ariely.
Publisher: Harper Collins Publishers.
Reviewed by: Salman Ahmed Shaikh

Predictably Irrational is a book by Dan Ariely published by Harper Collins Publishers. This book aims to show how apparent irrationality in behaviour can be explained. The book takes lively examples where humans act strangely and shows how such actions can be explained. Behavioral finance tries to explain anomalous behaviour caused by the psychological biases in human cognition and irregularities in human behavior. The field has identified various biases and behavioral irregularities that have been established in empirical studies and experimental research. Representative heuristic, herd behaviour, disposition effect, anchoring and loss aversion are important concepts which further enrich our understanding of human behaviour and choices.

Nonetheless, the narrow confinement of behaviour within a restricted sense of self-interest does not enable us to explain pro-social choices and actions adequately. For understanding such behaviour, there is need for broadening the vision. This book attempts to explain some choices, actions and behaviours which apparently look irrational, but which are not if further explanation is pursued and contemplated. However, the limitation of mainstream economics framework is that it can only incorporate pro-social behaviour by widening the scope of self-interest rather than undermining its impulse. Therefore, mainstream economics still remains neutral on ethical concerns and the call for affirmative actions. Humans are much more than utility maximizing machines. They are capable of using both material rationality and moral rationality to differentiate right from wrong and need reinforcement to adopt virtues influenced by an inner urge other than just material interests.

Some studies suggest that preferences – which are taken exogenously in most mainstream economic models – are amenable to different social experiences, learnings and cultures. Indeed, if preferences are amenable and social behaviour is learned like other behaviours, then we ought to acknowledge this. This could help in cooperative pro-social campaigns; lasting and fruitful social partnerships; and strengthening of social capital that could potentially relax pressure from the public sector. In weakly governed countries, social networks assume roles typically provided by market-based financial intermediaries or the public sector. In economics education, acknowledging these
differences, experiences, success stories and alternate visions of policy, broadens the perspective and enriches the solutions toolbox to meet sustainable development challenges which require strong mutual understanding and efforts of diverse cultures towards a common vision of future.

Islam offers a worldview which not only satisfies the deep questions of philosophy about existence, but which also provides an integrated incentive mechanism to do good as an end in itself, rather than just because of self-interest, howsoever narrowly or widely defined. Now, what this discussion implies for Islamic economics. Islamic economics can admit micro foundations as a description of human behaviour in the economic way of life; however, the systems, institutions and policy-making offered by Islamic economics cannot take human behaviour as a rule, but only as a guide. Islamic economics cannot be just description of the animalistic pursuit of materialism.

In mainstream economics, the important issues of equity, welfare and equitable distribution are at the periphery rather than at the center of curriculum and research. That is where; Islamic economics has something distinctive to offer. The mandate of Islamic economics will be to explain the economic merit of Islamic socio-economic institutions using experimental and observational data and by applying statistical and other suitable techniques to establish certain analytical hypotheses.
Country Model

Morocco

Morocco can be considered the most advanced of North African neighbours in developing Islamic finance. One of Africa’s largest and most sophisticated economies, Morocco is taking assertive measures to boost its infrastructure and make itself more appealing to foreign investors, and this includes being a Muslim-friendly investment destination. The Kingdom is making efforts in positioning itself as an attractive Islamic finance market as it endeavors to make its regional financial hub (Casablanca Finance City) ambition come true.

Regulatory Environment

Since passing an Islamic finance bill in November 2014, Morocco has continued working toward strengthening its regulatory framework to facilitate Shariah compliant banking and financial services. In February 2015, the Higher Council of Ulemas established a new commission dedicated to Islamic banking and in July the same year, the Ministry of Finance and Economy approved an earlier circular outlining the banking licensing process including for Shariah compliant units.

Banking and Finance

Morocco’s financial system is considered the most efficient in the MENA region because of its competitive and sophisticated capital market; its insurance industry that is positioned as the second largest in Africa and its mature and developed banking sector.

While official regulations were not passed until 2014, several Islamic banking products such as Ijarah, Musharaka and Murabaha were made available via conventional banks since 2007, although the take-up was limited. There were efforts to launch an Islamic window via Bank Wafa; however, that failed following political oppositions. It was in January, 2017 that the Bank Al-Maghrib, Morocco’s central bank, announced the approval of five banks to provide Sharia-compliant products and services. The new legislation uses the phrase ‘participatory’ banking, rather than ‘Islamic’ banking, in a bid to encourage private firms to operate independently from the question of religion. The central bank has also established a central Shariah board to oversee the industry. Three of the five authorized institutions are leading national banks, while the central bank has also given approval for the subsidiaries of three leading French banks to offer Islamic products.

Takaful

In May 2015, the Moroccan government approved an insurance bill which introduced the concept of Shariah compliant insurance and details guidelines for running takaful and re-takaful operations including the segregation of funds and Shariah
governance. The central bank is considering establishing an Islamic interbank market and working on sovereign treasury Sukuk issuances in order to support the Islamic finance industry.

**Future Outlook**

The demand for Shariah finance services in the North African country is significant as demonstrated by the number of foreign players keen to expand their geographical footprint into the market. These players are attracted by Morocco’s Muslim demographics, strategic location as a gateway between Europe and Africa and also its position as one of the region’s top economies. Islamic financial products have been projected to be worth US$7 billion by 2018, less than 5% of the expected total market share, according to the Moroccan Association of Participative Financiers.

Islamic finance opportunities may be lucrative in Morocco, with many eager to jump at them; however, in order for the potential to be realized, the regulatory infrastructure needs to be further bolstered such as in the areas of Islamic insurance and tax. The country will also need to look at developing Shariah liquidity instruments, as at present, Morocco’s financial market lacks liquidity and foreign investment. The introduction of Islamic banking will therefore help increase financial inclusion, investment stability and accelerate economic development for the nation. It has also been predicted that there will be a rise in the use of contactless payments and Sharia-compliant credit cards.

**Sources of Information**

- Central Bank of Morocco website https://www.bkam.ma
- www.islamicfinancenews.com
- https://www.islamicfinance.com/
- https://www.worldfinance.com/
- http://www.reuters.com/
The Perils of Usury

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Interest Payment on External Debt (% of GNI) for Selected OIC Countries

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Source: World Development Indicators 2015
Note to contributors

Journal of Islamic Banking and Finance is an official publication of International Association of Islamic Banks Karachi, Pakistan. It is a refereed quarterly journal, as well as a pioneer in the field of Islamic banking and finance being published since 1984. It provides a forum for researchers, particularly in Islamic Banking and Finance, wishing to share their expertise with a vast intelligentsia in the form of articles, research and discussion papers and book reviews. Major areas of interest for the journal include: (i) Theoretical issues in banking and financial industry specially from Islamic perspective; (ii) Empirical studies about the Islamic banking and financial institutions; (iii) Survey studies on issues in Islamic banking and finance; (iv) Analytical studies of applied Islamic banking; (v) Comparative studies on Islamic and conventional banking systems; and (vi) Short communications and interviews investigating the perceptions of leading bankers and banking experts as well as policy makers.

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