

The Application of Profit-Loss Sharing (PLS) Contracts in Malaysian Islamic Financial Industries: Perspectives, Challenges and Prospects

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Abstract: Regardless of the quasi unanimity of Islamic economics and finance scholars on the importance of *Mudārabah* and *Mushārahah* in the Islamic financial institutions (IFIs), and together with the dominance of the concept of profit-loss sharing (PLS) in the theoretical literature, the allocation of most Islamic funds specifically in Islamic banks is confined to short-term and low-risk investments. This study has been conducted to find the factors leading to the paradoxical differences between what is being idealized and what are being practiced in the Malaysian Islamic finance and banking industry. The findings of this study were based on primary data gathered through interviews with eight (8) Islamic Financial Institutions (IFIs). This study found a number of factors why IFIs seem to be reluctant to implement *Mudārabah* and *Mushārahah* contracts. among them are because of the attitude of the Islamic financial service providers, high level of risks, the role of the bank as fund provider instead of partner or investor, inadequate demand from customers, complexity in implementing the products, stringent regulations and lack of expertise and skilled staff. Based on the findings of this study, several recommendations that can be implemented in order to encourage wider application of *Mushārahah* and *Mudārabah* contracts by the IFIs have been suggested.

Keywords: Profit-loss sharing (PLS), *Mushārahah*, *Mudārabah*, Islamic financial institutions (IFIs), Islamic banking system

1. Introduction

Islamic finance and banking industry has evolved rapidly during the past few years from merely an alternative form of financial intermediation for Muslims to become a complete, competitive and integral component of the mainstream global financial system that serves both Muslims and non-Muslims worldwide. The introduction of Islamic banking to the financial system is in a vision to move from a debt-based financial intermediary to an equity-based and risk-sharing arrangement (Wajdi, 2007). An ideal Islamic banking model is reflected through its balance sheet structure that is dominated by profit-loss-sharing (PLS) in terms of both assets and liabilities. Theoretically, Islamic banking is deemed to be a good alternative to the conventional system due to its robustness and the potential stability that the system may provide (Khan & Mirakhor, 1987; Siddiqui, 2001). Most scholars of Islamic banking and finance subscribe to the view that PLS based financial instruments such as *Mudārabah* and *Mushārahah* represent the true spirit of Islamic banking system. Despite the quasi unanimity of Islamic economics and finance scholars on the importance of *Mudārabah* and *Mushārahah* in the Islamic banking system, and together with the dominance of the concept of PLS in the theoretical literature, the allocation of most Islamic funds is confined to short-term and low-risk investments with a slim profit margin (Dar & Presley, 2000). *Mudārabah* and *Mushārahah* only constituted a negligible portion of both the assets and liabilities of Islamic banks.

In Malaysia, even though the development of products and services in the Islamic banking system is very encouraging, financing products that are based on the *Mudārabah* and *Mushārahah* principle are almost non-existent. The assets and financing activities of Islamic banking in Malaysia appeared to be concentrated on non-PLS modes of financing such as *Bay' Bithaman al-Ajil (BBA)*, *Bai' Inah*, *Murābahah* and *Ijārah*. For example, in Malaysia in 2010, the total financing of the IFIs amounted to RM204 billion. Of this, BBA constituted 28 percent (RM57 billion), *Bai' Inah* (RM57 billion), *Ijārah* 23 percent (RM46 billion) and *Murābahah* (RM23 billion). Only two percent of the total financing in 2010 were constituted by *Mushārahah*-based products (RM3.6 billion), while *Mudārabah* represented only 0.06 percent of the total financing. In 2011, the total amount of financing increased to RM 249 billion. Of this, *Bai' Inah* contracts amounted to RM69 billion, which constituted 28 percent of the total financing of IFIs. BBA contracts represented 27 percent of the amount (RM68 billion), *Ijārah* 22 percent (RM34 billion) and *Murābahah* 13 percent (RM31 billion). *Mushārahah* still remained at 2 percent of the total amount with RM5.7 billion while the proportion of *Mudārabah* dropped to 0.04 percent with RM93 million.

The concentration on non-PLS modes of financing i.e. *Bay' Bithaman al-Ajil (BBA)*, *Bai' Inah*, *Murābahah* and *Ijārah* raises the question of whether Islamic finance and banking operations in general are totally Islamic or whether the name is merely used as a "veil" by bank to attract funds from Muslim investors. Thus, this study has been conducted to find the factors leading to the paradoxical differences between what is being idealized and what are being practiced in the industry. The study examined the issues within the scope of the Malaysian Islamic finance and banking industry. This paper is organised as follows. Following this section, section two reviews previous studies on *Mudārabah* and *Mushārahah* contracts. Section three discusses methodology. Section four presents results. Section five concludes the paper.

2. Literature Review

*Mudārabah*¹ is a form of contract in which one party (*rabb al-mal*) provides capital while another party (*mudarib*) undertakes a commercial enterprise. Any profit from the venture is distributed between the parties based on a ratio agreed beforehand, while any loss is entirely borne by *rabb al-mal*. As for *Mushārahah*, it can be defined as a joint enterprise formed for conducting some business in which all partners (two or more) share the profit according to the specific agreed ratio while loss is shared according to the ratio of their contributions (Usmani, 2004). It is accepted by most scholars in Islamic banking and finance that a banking system constructed to promote risk-sharing, co-operation and mutual assistance is reflected in the principle of PLS which, in turn, is the cornerstone of Islamic finance and banking (see for example Qureshi 1945; Ahmad 1947; Siddiqi, 1983; Khan & Mirakhor, 1987; Ahmad, 1994; Hassan, 1999; Haron, 2000; Ahmad, 2000; Warde, 2000; Siddiqui, 2001; Rosly & Bakar, 2003; Usmani, 2004; Choudhury & Hussain, 2005). These authors place greater social and religious responsibilities upon Islamic banks. Contrary to conventional banks, the authors believe that Islamic banks need to achieve socio-economic objectives, which encompass aspects such as social justice, economic growth, efficiency and stability. These objectives can be better served through the use of *Mudārabah* and *Mushārahah* contracts.

However, what is being practiced by the IFIs is far from these idealized models. Only very small portions of their funds are invested using the *Mudārabah* and *Mushārahah* contracts. Several studies have pointed out that *Mudārabah* and *Mushārahah* financing have declined to almost negligible proportions (Aggarwal & Yousef, 2000; Lewis & Algaud, 2001; Kuran, 2004; Yousef, 2004; Iqbal & Molyneux, 2005; Wajdi, 2006). This trend is observed in all countries, for example, Dar and Presley (2003) revealed that in 1998, the Dubai Islamic Bank allocated only 10 per cent of its total funds for PLS contracts, while three percent and four percent were allocated by the Jordan Islamic Bank and Qatar Islamic Bank respectively. The authors also show that the Islamic Development Bank (IDB) has so far not used PLS in its financial businesses, apart from a few small projects. Furthermore, according to Dar and Presley (2003) even specialized Islamic firms such as *Mudārabah* companies (MCos) in Pakistan, which are supposed to function purely on a PLS basis, invest only a negligible proportion of their funds in the *Mudārabah* and *Mushārahah* systems. According to Mehmet (2007), the lack of *Mudārabah* and *Mushārahah* financing products is due to the preference of IFIs for more profitable and less risky debt-financing products such as *Murabahah*. Indeed, nearly all Islamic banks, investment companies and investment funds offer trade and project finances based on a mark-up, commissioned manufacturing or leasing (Dar & Presley, 2003). Yousef (2004) described this phenomenon of over reliance of debt-based financing by IFIs as the *Murabahah* syndrome. It has been stated by Wajdi (2007) as the ideal structure of Islamic banks which is supposed to be based on profit-loss sharing (PLS) indeed proves to be a mirage as very little of Islamic banks assets are based on PLS contracts. This circumstance raises the question of whether the essence of risk-taking and value addition, which are indispensable social imperatives and hence Islamicity, seem to have been lost (Rosly & Abu Bakar, 2003).

Given this scenario, there is clearly a need to study the reasons behind this paradoxical difference between what is being idealized by the Islamic economists and *Shariah* scholars and what are being practiced in the industry. Even though quite a substantial number of studies have been conducted to

¹The term *Mudārabah* is used by the Hanafi and Hanbali Schools, whereas the Maliki and Shafi'i Schools prefer the term *qirad* (Chapra, 1985). In Malaysia, although the majority of Muslims follow the Shafi'i School, *Mudārabah* is used.

elucidate the reasons behind this trend, they are relatively too general in context and some of them are not based on empirical data or information. The majority of them were mostly theoretical in nature and dealt mostly on the rules of *Mudārabah* and *Mushārahah* contracts as well as justifications on why they are preferable in Islamic banks (see for example Qureshi, 1945; Ahmad, 1947; Siddiqi, 1983; Khan & Mirakhor, 1987; Ahmad, 1994; Hassan, 1999; Haron, 2000; Ahmad, 2000; Warde, 2000; Siddiqi, 2001; Usmani, 2004; Choudhury & Hussain, 2005). There have been also some empirical studies that looked into the performance and practicality of implementing the *Mudārabah* and *Mushārahah* contracts and these include studies conducted by Rosly and Bakar (2003), Dar and Presley, (2003), Sundarajan and Errico (2002) and Shaharuddin (2010). However, these studies are mostly based on secondary data and not on primary information obtained from in-depth interviews with industrial practitioners.

3. Methodology

This paper will be more specific in nature by examining the issues within the scope of the Malaysian Islamic finance and banking industry. In this paper, we will base our analysis on the data gathered from face-to-face interviews with representatives from selected IFIs who are directly involved in dealing with *Mushārahah* and *Mudārabah*-based products i.e. the officers/persons in charge in the Product Development Department, Credit Department, Legal Department, *Shariah* Department and Risk Management Department. For the purpose of this study, we have selected eight of these institutions to be interviewed. The eight institutions comprise one full-fledged local Islamic banks, two full-fledged international Islamic banks, three Islamic banking subsidiaries of local banks and two financial development institutions. For this paper, these eight institutions are namely as Bank A, Bank B and etc.

4. Results

From the data that were gathered from the interviews with officers from eight Islamic financial institutions, we summarized the findings as below;

A. Attitude of the IFIs towards the *Mudārabah* and *Mushārahah* Contracts: The majority of the IFIs interviewed are found to be not very keen on implementing *Mudārabah* or *Mushārahah* concepts for their financing activities. There were a number of reasons cited by these IFIs to explain this behavior. Some of the IFIs stressed that due to the competitive environment of the banking sector nowadays, it is important for them to secure profits with low risks (i.e. Bank A and Bank C). However, by offering *Mudārabah* or *Mushārahah*-based products, they may be able to obtain higher profits while the risk level will also be high. All of the interviewed IFIs also mentioned the fact that as banks, they were fund providers and not investors. If they were to offer *Mudārabah* or *Mushārahah*-based products, they would have to play the roles of an investor, which would entail different types of commitment and responsibilities. On top of that, Bank C mentioned it lacks human resource and expertise (such as project manager, product specialists, engineers and other professionals) who may be required to manage projects which were financed using the *Mudārabah* or *Mushārahah* concepts. The bank also emphasized the fact that as a profit-making organization, it may not want to employ technical staff with limited job scopes.

It is interesting to note that two of the banks even questioned the needs for IFIs to offer *Mudārabah* and *Mushārahah* financing (i.e. Bank C and Bank F). According to these banks, there was no *nas* or *dalil* from the '*Al-Quran*' or '*As-Sunnah*' that clearly indicate the needs for IFIs to offer *Mudārabah* and *Mushārahah* financing. The banks interviewed also highlighted the fact that there had been no incentive provided to them by the government in order for them to offer more *Mudārabah* and *Mushārahah*-based products. This according to the bank may signify that the government had no intention of pushing for a wider application of *Mudārabah* and *Mushārahah* concepts by the IFIs. In spite of this seemingly negative attitude towards *Mudārabah* or *Mushārahah* financing among the interviewed IFIs, there were still some IFIs (i.e. Bank A and Bank B), which still believe in the importance of IFIs to offer products based on these two principles. According to these banks, it is not a matter of willingness but rather a matter of practicality that hindered them from venturing further into these kinds of financing products. Both of these banks believed that if proper measures were to be introduced by the relevant authorities, IFIs in Malaysia should be able to offer more *Mudārabah* and *Mushārahah* products.

B. Challenges: Our interviews with the practitioners of Islamic banking show that there were a few matters that they were concerned with the implementation of the *Mudārabah* and *Mushārahah* contracts. Among the major concerns mentioned by the IFIs were the high level of risks associated with these

contracts, lack of experts and expertise, dual banking landscape, complicated legal documents, asymmetric information and customers demand. This section will discuss further these concerns.

- i. **High Level of Risk:** Risk is one of the main challenges raised by the IFIs interviewed in adopting *Musharakah* and *Mudarabah* contracts. The respondents in all of the IFIs expressed their concern on the high level of risks inherent to these concepts. Therefore, for these banks, unless this issue has been taken care of, it would not be possible for them to offer these products. Furthermore, according to them, prior to implementing these concepts, an innovative model of project and company valuation would need to be developed first. This model would enable the IFIs to assess the performance as well as the value of projects at the different stages of their lifecycle. The model would also be necessary in case one of the parties wanted to make premature exit from the venture. The model should also be able to assess the value of the project at all stages of the venture. Unfortunately, due to particular to technical difficulties, no such model had been developed yet. In addition, Bank C was concerned with the high level of weighted risks required for these concepts i.e. 400 percent as stated in Basel II. According to Bank D and Bank G, Basel II was not very accommodative to the *Musharakah* and *Mudarabah*-based products. On the other hand, Bank E stressed that *Shariah* Non Compliance Risk could also be a major concern in *Musharakah* and *Mudarabah*. Since the project would normally be a long-term project, the bank might not be able to continuously monitor the project in order to ensure that it complied with the rules of *Shariah*.
- ii. **Lack of Expertise:** Lack of expertise was another major concern raised by the interviewed IFIs. Bank A, Bank E and Bank F stressed the difficulty in finding and hiring experts to monitor the *Musharakah* and *Mudarabah* projects. They also stressed their difficulties in retaining these experts. As for Bank C, it was not really the difficulty in hiring experts that was of concern to them as they were readily available in the market. Rather, it was the high costs that were associated with the hiring of these experts that concerned them. As such, they are in the view that a larger portion of the profits obtained from projects financed using the *Musharakah* and *Mudarabah* concepts should be accorded to the banks to compensate for the higher costs that they would have to bear. However, this in a way would make these products less attractive to the customers as they would be more expensive as compared to other financing products.
- iii. **Banking Landscape geared more towards the Conventional System:** Bank C and Bank D highlighted the issue related to the practice of a dual banking system in Malaysia. According to them, even though the conventional and the Islamic banking system exist in this country, the banking landscape and its development were still very much determined and influenced by the former. Furthermore, customers were continuously comparing Islamic banks with their conventional counterparts especially in terms of the products they offer. Therefore, despite all the advantages that a dual banking system had to offer, it also provided customers with the option of moving easily from one system to another. If they found that the product offered by one banking system was not suitable to them due to reasons such as costs (too expensive) or convenience (too complicated), they could easily look for similar products offered by another system. This has serious implications on the practice of Islamic banks in Malaysia, because to remain competitive, the products they offer would have to be similar to or in line with the ones being offered by their conventional counterparts. This also explains why financing products based on the concepts of *Musharakah* and *Mudarabah* remain unattractive for the Islamic banks as there has been no equivalence to such products that have been offered by conventional banks. In relation to the above, Bank B was in of the view that Islamic banks might need a longer time to propagate the concepts of *Musharakah* and *Mudarabah* to the customers and change customers' perceptions towards the Islamic banking system. Furthermore, the theoretical part of these concepts may be difficult to be practiced in the real world.
- iv. **Complicated Documentation Process:** Some of the banks considered financing under the *Mudarabah* or *Musharakah* concepts as being too complicated especially in terms of its procedures and legal documentation (i.e. Bank C, Bank D and Bank G). Bank C commented that in practice, it would be difficult for the IFIs to offer a stand-alone product that was based solely on the concept of *Musharakah* or *Mudarabah*. According to this bank, if IFIs were to offer any product based on the concepts of *Musharakah* or *Mudarabah*, it would have to be in combination of different contracts in one transaction. Therefore, the documentation for this kind of product might become very complicated in order to fulfill all the requirements of the contracts involved.
- v. **Asymmetric Information:** Bank C and Bank E were concerned with the problem of asymmetric information that might limit their capacity to monitor and control projects financed using the concepts of *Musharakah* or *Mudarabah*. According to these banks, customers might not disclose the actual fact of the proposed project when they apply for financing from the IFIs. Bank G and Bank H

also raised the issue of the involvement of IFIs in the management of the projects financed by the *Mushārah* and *Mudārah* principles. According to these banks, since under the concept of *Mudārah* the bank had to bear all the risks associated with the projects; therefore, they should be provided with an avenue in which they could voice their views on the way the project had been managed in order to make sure that the project was successful. However, there was an issue as to what extent IFIs could be involved in the decision making of the board of directors. There was also an issue of compliance with current regulations regarding the role of IFIs as financier and member of board of directors.

- vi. **Inadequate Demand from the Market:** Bank B, Bank D, Bank E and Bank F raised the issue of inadequate demand from customers to subscribe the *Mudārah* and *Mushārah*-based products. According to Bank D, they would only offer products that had demands from the market. There was no point for them to offer products, which would not be of demand to the market. According to these banks, the lack of demand for *Mudārah* and *Mushārah*-based products was due to various reasons. Most importantly, under the principle of *Mudārah* and *Mushārah*, the profits will have to be distributed to both the IFIs and the project owners. However, some customers were only looking for a source of financing and not for a business partner. Therefore, they may shun *Mudārah* and *Mushārah*-based products as the latter will require them to not only share their profits with the banks but also to allow the banks to oversee the running of their project. Customers may for example be required to provide periodical reports on the progress of the project to the IFIs, which they do not have to do if their relation with the bank remains as lender-borrower. Bank B also pointed out the fact that customers would always look for the cheapest alternative and *Mudārah* and *Mushārah*-based financing products if they are offered, may cost more to the customers. According to the bank, this was due to the lack of understanding of the public in general on the principles and purpose of Islamic banks. For them, what matters most was to obtain the funds needed to finance their project at the lowest cost possible. Also, according to Bank B, banks as a solution provider would provide the solution that best suited the needs of their customers. However, if the customers were to understand the principles that underlie Islamic banking practices, they might be willing to bear the extra costs.
- vii. **Other Issues:** There were also other issues that have been raised by the IFIs, which were interviewed:

Bank B

1. Legal issues inland and property dealings involving banking products of Islamic foreign bank (ownership, dealings etc.).
2. The dependency of Islamic Banking on the conventional benchmark in determining profit rates.

Bank E

1. No comprehensive guidelines from BNM in terms of monitoring default and negligence by contracting parties.
2. Human resources gap and incompetent fresh graduates produced by higher learning institutions who do not meet industry requirements.

Bank G

1. No interaction between the regulator and the IFIs in drawing up of regulations regarding *Mudārah* and *Mushārah*.

5. Conclusion

As *riba* is clearly prohibited, Islamic economists viewed the PLS modes of financing i.e. *Mudārah* and *Mushārah* as the types of contracts that IFIs should be focusing on. However, in practice, IFIs seem to shun these two types of contracts in favor of other less riskier and more profitable contracts such as *Murabahah*, *Bay' Salam*, *Istisna'* and *Ijarah* leading to what is termed as a '*Murabahah syndrome*' (Ali & Ahmed, 2006). Therefore, this paper is aimed at providing an understanding pertaining to the causes behind these paradoxical differences between what is being idealized and what is being practiced in the industry. Our findings show that there are a number of reasons why IFIs seem to be reluctant to operate or implement *Mudārah* and *Mushārah* and these include the level of risks that is too high, the role of the bank as fund provider instead of partner or investor, inadequate demand from customers, complexity in implementing the products, stringent regulations and lack of expertise and skilled staff.

Recommendations: From our findings, the following are recommendations that can be implemented in order to further encourage the use of *Mudārabah* and *Mushārah* contracts by the IFIs.

- i. One of the main concerns raised by the IFIs concerning the *Mudārabah* and *Mushārah* contracts is the high risks that are inherent to these types of contract. Therefore, to minimize the exposure to risks, the following measures can be implemented.
 - a. It is suggested that the roles of existing third party guarantors. In Malaysia, for example Credit Guarantee Corporation (CGC) be enhanced as the corporation can also cover risks from *Mudārabah* and *Mushārah*-based products. In this matter, the relevant authorities should streamline the legislation regarding the roles and responsibilities of third party guarantors in the context of *Mudārabah* and *Mushārah* financing.
 - b. It is found that the nature of the IFIs itself in Malaysia is not very suitable for them to offer *Mudārabah* and *Mushārah*-based products. Therefore, it is suggested that the IFIs establish a subsidiary that will play roles similar to those of a venture capitalist. It is this subsidiary which will focus on looking for potential projects and providing them with financing based on *Mudārabah* and *Mushārah* contracts.
 - c. A special regulation should be introduced and/or harmonization efforts of the existing regulations should be undertaken in order to suit the principles of the *Mudārabah* and *Mushārah* contracts.
 - d. The relevant authorities should also look into the issue of negligence especially on the burden to prove the existence of negligence to mitigate the risks of *Mudārabah* or *Mushārah* contracts from being lopsided towards the detriment of the IFIs.
 - e. It is suggested that in the selection of potential *mudarib*, only those who are capable of bringing in some capital should be given priority. By requiring potential *mudarib* to provide part of the capital, the problem of asymmetric information could be reduced.
 - f. It should be noted that BNM has come up with a specific guidelines on the *Mudārabah* or *Mushārah* contracts for IFIs. The guidelines have clearly outlined specific measures in terms of risk management that IFIs should follow in order to mitigate the risks inherent in the *Mudārabah* or *Mushārah* contracts. It is suggested that these guidelines be further improved by making them more specific so as to be implemented by the IFIs intending to offer the *Mudārabah* or *Mushārah* contracts.
 - g. The IFIs could also be encouraged to offer *Mudārabah* and *Mushārah*-based product by providing special tax treatment such as tax waiver and tax neutralization for all proceeds obtained from financing projects using *Mudārabah* and *Mushārah* contracts. The special tax treatment given can be justified on the grounds of the higher level of risks that IFIs need to assume in providing these products. In order to encourage more entrepreneurs to use *Mudārabah* and *Mushārah* contracts, they could also be given special tax treatment on any proceeds obtained from projects financed using these contracts.
 - h. The dearth of *Mudārabah* and *Mushārah* products offered by the IFIs can be characterized, as a typical market failure problem, which refers to a situation when a market left to itself, does not allocate resources efficiently. In this case it can be argued that based on the premises of the advantages of the *Mudārabah* and *Mushārah* contracts against other types of financing, the economy of the *Ummah* could have been better off if more *Mudārabah* and *Mushārah* products were to be offered by the IFIs. Therefore, when market failures occur, there is a potential role for the government to improve the situation. In this case, the government should intervene more directly in order to increase the use of *Mudārabah* and the *Mushārah* contracts. It is suggested that the government and the government-linked companies be encouraged to use *Mudārabah* and *Mushārah* contracts in financing their development projects.
 - i. It is also suggested that IFIs have a paradigm shift in the way they view their role as an Islamic Bank and their understanding of the philosophy underlying Islamic Banking activities. It is disheartening to hear that some of the banks interviewed have even raised the issue of the necessity of having

Mudārabah and *Mushārahah*-based products. IFIs should also re-examine their role as fund providers and transform themselves into becoming service providers. It is suggested that IFIs be focused on their role as service providers (trustees) and delegate their investment activities to separate entities i.e. their subsidiaries.

- j. The IFIs interviewed have argued that there is very little demand from the public for *Mudārabah* and *Mushārahah*-based products. However, it can also be argued that this lack of demand maybe due to the lack of awareness among the public on the existence, the importance as well as the advantages of such products. Therefore, there is clearly a role to be played by the IFIs as well as relevant authorities to increase the public's awareness on the concept of *Mudārabah* and *Mushārahah* and their importance especially in terms of the economic development of the *Ummah*. This can be achieved through extensive and effective promotions through various platforms such as public forums, conferences, and electronic media to name a few.

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