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The journal is unique because it not only publishes articles of academic rigour but also articles by practitioners who have experience in applied Islamic finance. The journal also showcases current research works or ongoing projects research works or ongoing projects as short articles.

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In the Name of Allah, Most Gracious, Most Merciful. The global Islamic finance industry is an active market bustling with new announcements and promising indicators of progress. A handful of moves among industry participants worldwide in the last quarter of 2017 reflect the increased attention the industry is receiving from different stakeholders across sectors and markets. Some of the recent market developments include:

- Turkey’s sale of gold-backed bonds and lease certificates (ṣukūk) to attract gold savings held by households into the economy.
- Unprecedented interest in Shari’ah-compliant retirement vehicles received by the Turkish pension fund sector with a surge in demand for them as compared to conventional funds.
- The Federal Government of Nigeria’s debut ṣukūk worth Nigerian Naira 100bn (about US$277m) issued for the construction and rehabilitation of roads.
- AAOIFI’s publication of new regulations, notably the Financial Accounting Standard (FAS) 28, “Murabahah and Other Deferred Payment Sales”.
- The Malawi Government’s approval for the provision of Shari’ah-compliant banking products on a window basis.
- The UK Treasury’s promise to return to the sovereign ṣukūk market in 2019 with a reissuance of its 2014 GBP 200m inaugural issuance to reiterate the UK Government’s commitment to promoting Islamic finance.

One of the much-talked-about developments in the ṣukūk industry is the issuance of green sustainable and responsible investment (SRI) ṣukūk that corresponds to the concept of green bonds in the conventional market. Bank Negara Malaysia, Securities Commission Malaysia and the World Bank Group have been making joint efforts to support the commercialisation of green ṣukūk to engage the industry in responsible financing and promote sustainable development. In October 2017, Quantum Solar Park Malaysia Sdn Bhd issued the world’s largest green SRI ṣukūk worth RM 1bn (about US$236m). The proceeds were earmarked to finance the construction of three large-scale solar photovoltaic plants in the states of Kedah, Melaka and Terengganu. Earlier in July 2017, Tadau Energy Sdn Bhd issued the first green ṣukūk facility under Securities Commission Malaysia’s SRI Sukuk Framework. The issuance totalled RM 250m (about US$59m) for financing another solar project. Across the world, governments are demonstrating an increased commitment to building a more sustainable, eco-friendly economy. Cutting-edge technologies and responsible financing are key instruments for realising that aspiration.

The wide-ranging Islamic finance developments reflect the varied topics being discussed by academics and market participants. The contents published in the ISRA International Journal of Islamic Finance
Journal of Islamic Finance usually echo this diversity, and this December 2017 issue is no exception. The main articles discuss a wide array of topics, ranging from the economic theory of Islamic finance to corporate social responsibility (CSR), ُدامَانُ ُال-مِلْكِيَّة (ownership risk) and corporate demand for general ُتَكْفُل (Islamic insurance). The six shorter articles that follow examine various issues from Sharīʿah, accounting and legal perspectives.

The first article, “An economic theory of Islamic finance”, by Mabid Ali Al-Jarhi, attempts to provide an economic rationale for Islamic finance. The initial part of the paper discusses the lessons learnt from monetary, banking and finance theories with regard to Islamic finance. Relying on his previous work, Al-Jarhi’s (1981) proposed Islamic finance model, the author then argues that the application of Islamic finance in such a model would bring about distinct macro-economic benefits. These set the basis for establishing an economic rationale for Islamic finance, and thus, the author recommends some institutional reforms for contemporary market economies.

The second article, “CSR practices of Palestinian Islamic banks: contribution to socio-economic development”, by Abdalrahman Mohamed Migdad, pioneers the literature on Islamic banks’ CSR practices in Palestine. It examines the CSR practices by analysing the banks’ annual reports and by questioning practitioners and Sharīʿah board members. The paper finds that there was no specific CSR strategy adopted by the banks. They engaged in various projects that benefit the community, depending on their means and society’s needs. Banks’ practitioners and Sharīʿah board members endorsed the value proposition of CSR and seconded the idea that banks should involve more in CSR activities to further human well-being.

The third article, “The concept and application of ُدامَانُ ُال-مِلْكِيَّة (ownership risk): Islamic law of contract perspective”, by Lutfi Abdul Razak and Muhammad Nabil Saupi, studies the concept of ُدامَانُ ُال-مِلْكِيَّة and examines its applications in contemporary Islamic banking, Islamic capital market and ُتَكْفُل products. The authors argue that the concept of ُدامَانُ ُال-مِلْكِيَّة not only refers to ownership risks or uncertainties but also confers liabilities and responsibilities on owners. As such, the notion of ownership in Islamic commercial transactions should imply bearing the liability of loss to justify the earning of legitimate profits. The paper further identifies cases where this concept is not adequately applied in the practice of Islamic banking and finance. It thus calls for the proper understanding and application of ُدامَانُ ُال-مِلْكِيَّة by practitioners and regulators for the industry to move to its truer form of sharing risks and benefits.

The fourth article, “Corporate demand for general ُتَكْفُل in Malaysia”, by practitioners Hamim Syahrum Ahmad Mokhtar, Izwayu Abdul Aziz and Noraziyah Md Hilal, reports on a survey conducted by the authors to gauge corporate demand for general ُتَكْفُل business in Malaysia. The survey assessed corporates’ awareness on ُتَكْفُل insurance, their ُتَكْفُل/insurance needs, factors considered and experience gained when securing ُتَكْفُل insurance coverage. The findings of the survey are deemed useful in determining areas of opportunities to better position the ُتَكْفُل business in the market and pinpoint areas for improving the practices of ُتَكْفُل in Malaysia. One of the opportunities highlighted is the small and medium enterprise sector, which still represents an underserved market. One of the improvements suggested by the authors is for ُتَكْفُل businesses to accentuate the value propositions of ُتَكْفُل. Respondents were found to be relatively indifferent to the Sharīʿah-compliance status of their protection.

The short articles published in the ISRA International Journal of Islamic Finance delineate key research findings on some of the research undertaken by ISRA researchers and other academics. The purpose of these articles is as briefly mentioned below:
• “Preference shares: analysis of Sharī‘ah issues”, by Shamsiah Mohamad, Mezbah Uddin Ahmed and Mohd Bahroddin Badri, studies the Sharī‘ah non-compliant features of conventional preference shares and offers some recommendations that would help in structuring Sharī‘ah-compliant preference shares.

• “Financial reporting of intangible assets in Islamic finance”, by Syed Musa Alhabshi, Hafiz Majdi Ab Rashid, Sharifah Khadijah Syed Agil and Mezbah Uddin Ahmed, conducts a comparative analysis of accounting dimensions and Sharī‘ah requirements in the financial reporting of intangible assets.

• “Sharī‘ah non-compliant assets as rahn (pledge) in Islamic banking products: a fiqh perspective”, by Lokmanulhakim Hussain and Mohammad Mahbubi Ali, provides a Sharī‘ah analysis on the use of Sharī‘ah non-compliant assets as rahn and specifically examines the utilization of modern instruments such as shares, unit trusts, current accounts, investment accounts and insurance policy as pledges.

• “Contra trading in Bursa Malaysia Securities Berhad: a Sharī‘ah and legal appraisal”, by Noor Suhaida Kasri and Burhanuddin Lukman, analyzes the practice of contra trading in Bursa Malaysia Securities Berhad and examines the arising Sharī‘ah and legal issues.

• “The goods and services tax (GST) on tabārur ibad products: a critical Sharī‘ah appraisal”, by Burhanuddin Lukman and Saba’ Radwan Jamal Elattrash, discusses the Sharī‘ah view on the imposition of GST on tabarru‘-based tabārur ibad (donation-based Islamic insurance) products in Malaysia.

• “The effect of IFSA 2013 on late payment of tabārur ibad benefits”, by Muhammad Ali Jinnah Ahmad and Burhanuddin Lukman, examines the impact on the tabārur ibad industry in Malaysia of compensation for late payment of tabārur ibad claims imposed in the Islamic Financial Services Act (IFSA) 2013.

We are pleased to inform our readers that the *ISRA International Journal of Islamic Finance* has been successfully evaluated and accepted in the *Emerging Sources Citation Index (ESCI)* within Clarivate Analytics (formerly Thomson Reuters). Coverage is expected to begin with the June 2017 issue. As readers would be aware, ESCI is a new index in the Web of Science core collection and was launched in late 2015. As at date, *ISRA International Journal of Islamic Finance* is abstracted and indexed by: Index Islamicus, EconLit, EBSCO Products, ProQuest, Scientific Indexing Services, EconBiz, ESCI and the British Library.

We thank all the contributors for submitting their work to the *Journal*, and wish our readers a rewarding and insightful read.

Allah (SWT) is the bestower of success, and He knows best.

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An economic theory of Islamic finance

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Abstract

Purpose – This paper aims to provide an economic rationale for Islamic finance.

Design/methodology/approach – Its methodology is simple. It starts with listing the contributions to economic analysis relevant to the required rationale in the theories of banking, finance, price, money and macroeconomics, to identify the main rationale for Islamic finance. A concise description of the author’s model for an Islamic economic system, within which Islamic finance can be operational, is provided.

Findings – The paper finds distinct advantages of Islamic finance, when properly applied within the author’s model. Islamic finance can therefore be a candidate as a reform agenda for conventional finance. It opens the door for significant monetary reform in currently prevalent economic systems.

Research limitations/implications – The first limitation of the paper is that the distinct benefits of Islamic finance are all of macroeconomic types which are external to Islamic banking and finance institutions. They are therefore not expected to motivate such institutions to apply Islamic finance to the letter, without regulators interference to ensure strict application. The second limitation is the necessity to set up enabling institutional and regulatory arrangements for Islamic finance.

Originality/value – The results are unique as they challenge the received doctrine and provide non-religious rationale for Islamic finance.

Keywords Islamic finance, Islamic economics, macroeconomics, economic reform

Paper type Research paper

Introduction

Conventional finance, based on the classical loan contract, was practiced in the ancient world for centuries. The origin of modern banking has been traced back to Italy in the twelfth century (De Roover, 1943, 1954; Orsingher, 1967; Chachi, 2005). Meanwhile, interest-free Islamic finance started with the dawn of Islam, based on a number of investment and finance contracts. Yet, despite its continued application, it did not take the form of banking until 1975 (Chachi, 2005).

Islamic jurisprudence offers little with regard to the rationale of Islamic finance beyond the concept of justice underlying the prohibition of interest. Islamic finance involves higher contractual and transactions costs. Instead of using one standardized contract like the classical loan contract, it uses products based on numerous contracts, involving the possibility of mixing and matching as well as securitization.

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The first section of the paper details what we can learn from monetary, banking and finance theories with regard to Islamic finance. The second section provides a brief description of the Islamic finance model based on Al-Jarhi (1981). The third section attempts to list the advantages of Islamic finance, based on these theories. The fourth section discusses the problems associated with a mixed banking and finance system and how they can be surmounted. The last section draws policy recommendations.

**What we can learn from economic theory**
This section briefly delineates lessons we can learn from monetary, banking and finance theories with regard to Islamic finance.

*The rate of interest*
Islamic finance is based on a simple rule, which is to avoid trading present for future money at a premium. This effectively eliminates finance through debt, although it does not exclude providing interest-free loans for charitable purposes. Finance is provided through equity participation or profit and loss sharing (PLS) in return for equity or rights to share in pre-agreed proportions of profits. It is also provided through the sale and lease of assets in return for commitment to repay their value or for their usufruct at a later date. It is further provided against a commitment to deliver or manufacture commodities.

Can we find anything in economics that justifies apprehensions about trading present against future money at a premium, which is the rate of interest?

The theoretical work on the relationship between the level of the rate of interest and the optimality of resource allocation concludes that a zero nominal interest rate is a necessary condition for the optimal allocation of resources (Samuelson, 1958; Friedman, 1969)[1]. In a world of paper money, adding an extra unit of real balances costs the economy no real resources. A positive rate of interest becomes a positive cost of using money. It leads traders to economize on the use of money in transactions, thereby frustrating their attempt to fully benefit from the means of exchange in minimizing their transaction costs. To keep the same volume of transactions, traders will have to substitute real resources for money. Such substitution withdraws real resources from the production sector to the transactions sector, leading to a suboptimal level of output[2]. In contrast, reducing the rate of interest to zero removes all incentives to substitute real resources for money. The optimal level of output can therefore be maintained.

The use of general equilibrium models shows that a zero interest rate is both necessary and sufficient for allocative efficiency (Wilson, 1979; Cole and Kocherlakota, 1998). These results are found to be robust in a variety of models (Correia and Teles, 1997).

Milton Friedman suggests, “Our final rule for the optimum quantity of money is that it will be attained by a rate of price deflation that makes the rate of interest equal to zero”[3]. Friedman’s rule amounts to steadily contracting the money supply at a rate equal to the representative household time preference (Friedman, 1969, p. 34; Ireland, 2000). Friedman’s rule imposes an optimal rate of deflation on the economy. This in itself is symptomatic of denying the benefits of price stability and ignoring the serious inefficiency and redistribution effects of both inflation and deflation (Lucas, 1994). Economists have tolerated “low inflation” in their proposal that the central bank pursues an inflation target. Friedman’s rule obviously switches to a deflation target. Central bankers have generally adopted an inflation target, but would never seriously advocate a long-run policy of deflation (Wolman, 1997).
Less seriously, Friedman’s rule threatens to descend the economy into a liquidity trap when the rate of interest is zero (Uhlig, 2000). However, this can be avoided when Friedman’s deflationary policy can be exercised only asymptotically (Cole and Kocherlakota, 1998). Even if the asymptotic conditions are not fulfilled, short-term constraints on monetary policy can do the job (Ireland, 2000).

When the rate of interest becomes very low, monetary authorities have less leeway to adjust it downwards in the face of recession. Others propose alternative ways to overcome the zero-bound interest rates (Goodfriend, 2000). However, low interest rates have not provided relief during the international financial crisis of 2007-2012.

Many economists appear convinced that practical and conceptual problems involved with zero interest rates are all surmountable, notwithstanding the efficiency and redistribution effects of deflation. Perhaps for a good measure, monetary authorities are not expected to adopt the optimal monetary policy rule[4]. The inefficiency resulting from positive interest rates cannot be removed by a monetary policy rule. Switching to total reserves, as suggested by the Chicago school, is a serious institutional change, not just a policy rule. However, it is insufficient to remove the persistent inefficiency resulting from deflation.

Risk sharing and market structure
Risk sharing is a basic feature of the Islamic economic system. In the financial sector, households provide their funds to financial intermediaries on a PLS basis. Financial intermediaries supply funds to their users partly on PLS and partly on sale-finance basis. Islamic finance is sometimes likened to a participatory sport in which everyone plays (shares the risk) in contrast to conventional finance, which is likened to a spectator sport, where risk is borne only by a minority of players while the majority of spectators risk nothing (Al-Jarhi, 2004a, 2004b).

Kalemli-Ozcan et al. (1999) found a positive and significant relationship between the degree of specialization of members of a group of countries, provinces, states or prefectures, and the amount of risk that is shared within the group. This obviously confirms that risk sharing facilitated by a favorable legal environment and a developed financial system is a direct causal determinant of industrial specialization, thereby raising the efficiency of the economy as a whole. In an Islamic economic system, risk sharing goes beyond the mere integration of capital markets. It should be more prevalent through the financial market structure, producing more specialization and greater overall efficiency.

Conventional finance is almost void of risk sharing. On the resource mobilization side, fund owners provide their financial resources on the basis of the classical loan contract. Accordingly, banks taking deposits would guarantee both principal and interest on their customers’ deposits. On the resource use side, banks take risk only on collateral and not on entrepreneurial activities. The use of collateral enables banks to limit the monitoring of their borrowers without increasing default risks.

Similarly, in bond markets, issuers guarantee the payment of principal and interest, while bondholders do not share in the business risk of, nor do they monitor, bond issuers. Trading bonds in an open market provides information that can be collected and analyzed by bondholders. Monitoring the market of a certain bond appears to be less expensive than monitoring borrowers by banks. That is probably why bondholders are willing to accept lower interest rates than banks do. Consequently, corporate bonds are good competitors to bank debt (Contessi et al., 2013). However, the relative reliance on bonds will depend on legal and institutional factors, how developed financial markets are and the relative levels of information disclosure about firms (De Fiore and Uhlig, 2011). While banks and bond
markets compete over providing debt finance, stock markets and debt suppliers compete for market share in finance.

Taking the USA as an example, the debt equity ratio ranged from 117 per cent in 2004 to 126 per cent in 2013 (FRED, 2017). It peaked at 193 per cent during the international financial crisis in 2008, taking a declining trend from then on. Figure 1 depicts the debt-equity ratio in the USA between 2004 and 2013.

It can therefore be concluded that a significant proportion of financing in conventional economies is conducted through issuing government and household debt instruments as well as borrowing from banks. This is where financing economic activities involves no risk sharing. Risk sharing is found only in the stock market, where shareholders presumably share in the profit and loss of the firms whose stock they hold. However, almost all firms are leveraged, which means that risk sharing is limited in most cases.

**Banking and finance theories, information asymmetry and the lemon problem**

According to banking theory, finance users are far better informed about the use of funds than finance providers. Therefore, debt finance is riddled with information asymmetry leading to risks of adverse selection and moral hazard, and ultimately raising the risk of default. In parallel, equity finance providers can be exposed to investing in a losing venture, which would be riddled by the lemon problem.

In such a world, an entrepreneur who is more informed than fund suppliers would prefer to use internally available funds to invest in the firm. He would also prefer to use debt finance when more funds are required than internally available (Razin et al., 1998). The reason is that using equity finance would be interpreted as a belief that the stocks of the firm are overvalued.

Information asymmetry in debt finance can be reduced through complete monitoring, including ex ante, interim and ex post monitoring (Aoki, 2013) of fund users, which would be extremely costly. Banks would have to raise the lending rates of interest to cover the extra costs of monitoring.

**Figure 1.**

Debt-equity ratio, USA (2004-2013)

**Source:** Using IMF data (FRED, 2017), including both debt/GDP and market capitalization/GDP to calculate the debt-equity ratio.
monitoring costs. The lemon problem can be handled through the conduct and review of feasibility studies and/or financial analysis.

Governance has been used by universal banks[5] as they take equity in companies to monitor performance and ensure profitability. In this manner, they solve the lemon and information asymmetry problems at once. Universal banks would therefore be more effective monitors than commercial banks (Dewenter and Alan, 1997).

Shareholders’ participation in management reduces the firm’s incentives to substitute riskier for safer assets in equity finance. Meanwhile, the firm’s incentives to hide profits would be reduced by debt finance. A combination of both debt and equity finance would therefore be ideal.

Empirical studies confirm the advantages of using a combination of debt and equity finance to both banks and firms. Theoretically, banks are relatively more exposed to adverse selection during economic booms and to moral hazard during recessions. Empirical studies have confirmed that universal banks face lower risk than commercial banks during both booms and busts. Wider and more significant risk differentials have been found between universal and commercial banks during downturns (Dewenter and Alan, 1997).

**Price and monetary theory**

The distinction between nominal, real and semi-real transactions is first examined (Al-Jarhi, 2002). Nominal transactions have two nominal (monetary) counter values. One example of a nominal transaction is when spot money is traded against future money. Another example is when the price of a gamble is paid as present money against the uncertain future payoff of the gamble, as in the case of derivatives[6]. Nominal transactions represent trading present against future money as well as risk trading. Both types of nominal transactions are not allowed in Islamic finance.

The macroeconomic effects of nominal transactions take two forms. In the first form, the growth in the volume of nominal transactions will encourage investments in the debt-trading and risk-trading industries and their associated services, like clearing mechanisms, strategic trading mechanisms and enforcement mechanisms.

The resulting redistribution of wealth would have effects on the consumption pattern in the economy and motivate reallocation of resources to the extent that consumption and investment preference differ among winners and losers.

Real transactions have only one nominal or monetary counter-value, while the other is always a commodity. Such transactions provide important indicators for the allocation of resources. When the rate of monetary expansion increases, more money is available for spending, either directly or through the increase in the availability of finance. Spending would increase on commodities as well as on debt- and risk-trading.

An increase in spending on commodities is done through real transactions, which become the chariot of the transmission mechanism from the changes in money supply to commodity markets directly. The more spending increases go through real commodities, the faster commodity markets would move to a new equilibrium. However, the more spending is directed to debt- and risk-trading, the greater the leakages as spending on commodities would await the conduct of financial market games and the resulting payoffs. Those gaining wealth would, after some delay, increase their commodity purchases by carrying out more real transactions. Such delay and leakages to nominal transactions slows the speeds of adjustments in commodity markets.

Therefore, the effect of policy actions leading to an increase in monetary expansion on commodity markets would depend on how much of the increase in the money supply goes into nominal versus real transactions[7].
Semi-real transactions can be defined as the exchange of one currency for another currency, where both counter-values are paid spot. Trading currencies against each other, where one or both of the counter-values is deferred, would be considered a nominal transaction. Spot trading of currencies would be for the purpose of paying for commodities across borders. They, therefore, have the same effects as real transactions. Meanwhile, currency trading with deferred payments would be for the purpose of debt- or risk-trading.

A concise Islamic finance model based on Al-Jarhi (1981)

The evaluation of Islamic finance in light of the above contributions to economics will depend on the institutional structure that would replace interest-based finance with interest-free finance. Al-Jarhi’s (1981) model keeps the market mechanism while introducing features that replace interest-based finance with interest-free finance. The institutional structure should be sufficiently comprehensive to encompass money creation and allocation, as well as monetary and fiscal policies. The details of the model are not reviewed in this paper. Instead, this paper attempts to provide a summary picture of how Islamic finance operates in such a model[8].

Money is issued in Al-Jarhi’s model in the form of central bank investment deposits or central deposits for short (CDs) with banks, placed on the basis of PLS. The return on CDs would flow back to the central bank as seigniorage for the ultimate benefit of the government budget.

Al-Jarhi’s model includes a system of total reserves. The fractional reserve system leads to unjustifiable wealth redistribution in favor of bank shareholders against the public. It provides the central bank with less than full and direct control over the money supply, as banks jointly create derivative deposits in multiples of the currency issued by the central bank. The use of fractional reserves as a tool of monetary policy leads to enormous changes in the money supply. To avoid such disadvantages, total reserves are prescribed.

The central bank issues money-market instruments whose proceeds would be added to central deposits, called central deposit certificates (CDCs). They would be negotiable in the secondary market and available to banks and the public for investment. The central bank would anchor monetary policy to the rate of return on CDCs (RCDC), which in contrast to the rate of interest, would be market determined.

Like the central bank, the public places their funds in investment accounts, based on PLS. The public can also hold CDCs. In addition, they can place demand deposits with banks which are used for transaction services and earn no return. On the fund-use side, people can finance their activities based on one of many contracts used in Islamic finance.

The question is what happens to government budget deficits? First, the government finances its income-generating activities through banks. Even infrastructure projects can be made income generating to attract finance on market terms. Second, citizens could be encouraged to establish awqāf (public foundations) to provide public services, especially education and health[9]. To the extent, such awqāf are encouraged, the government will limit its activities in this regard to setting standards for education and health services.

Redistribution in favor of the poor is done outside the market mechanism through the collection of zakāh (alms giving), for which banks become custodians as well as being authorized to use the proceeds to finance micro projects whose titles are transferred to the poor to make them self-employed as well as self-sufficient.
There would be no integrated debt market, and no risk trading would be allowed. The central bank, having an exclusive power to control the money supply, can gauge the rate of monetary expansion to the rate of growth to target absolute price stability.

In the next section, the advantages of Islamic finance are discussed. These advantages are subject to the assumption that Islamic finance is properly practiced, with an honest and strict adherence to its paradigm. Products that fall outside the mainstream interpretations, like *tawarruq* (three-party sale), *bayʿ al-ʾinah* (sale and buy-back), debt sale and the like are assumed away, despite their predominance. In addition, banks are assumed to strike a balance between PLS and sale finance, so that finance products would reflect a reasonable mixture of equity and debt-creating finance.

**Efficiency of Islamic finance**

The distinct benefits of Islamic finance are all of macroeconomic types that are external to Islamic banking and finance institutions. These are briefly discussed below.

*Efficiency and economizing on cash in transitions*

At the macroeconomic level, Islamic finance avoids the use of interest-based lending. The rate of interest is replaced by the RCDC. Such rate reflects the time value of money not against itself but against commodities.

The main purpose of the Friedman optimal monetary-policy rule (to deflate the economy at a rate equal to the real rate of interest)[10] is to prevent agents from substituting real resources for money in transactions, as this would reduce total output below the optimum level. Those who deposit their money in banks do so in the form of saving and investment accounts that are based on PLS. In this case, the rate of return would be uncertain. Neither the principal nor the return on such accounts or deposits is guaranteed. There would be no incentive to reduce the use of cash in transactions gain more income with certainty, as in the case of the classical loan contract.

*Efficiency and financial resource allocation*

Borrowers’ ability to repay loans is the primary factor in allocating financial resources in conventional finance. Islamic finance, through equity and PLS modes, would focus on the profitability of the concerned investment. Financial resources would therefore be directed to the most productive investments, thereby improving the efficiency of the financing process and reinforcing efficiency in the real sector.

Islamic finance provided through the modes of commodity acquisition, with sufficient competition among fund users, ties the cost of finance at the margin to the relative value in use of each commodity in consumption or production. Financial resource allocation would therefore be optimal. No finance would be provided for debt or risk trading[11].

*Stability*

The liabilities of a conventional bank that include demand, time and saving deposits are guaranteed by the bank[12]. On the other hand, its assets are composed of debt instruments whose quality depends on debtors’ ability to repay. Default, which can be expected at times of crises due to macroeconomic factors or to bank-specific circumstances on the asset side, threatens banks’ ability to meet their obligations on the liability side.

An Islamic bank has liabilities of a different nature. Only demand deposits are guaranteed, but investment deposits are placed on a PLS basis. When a bank faces
Macroeconomic or bank-specific crises, investment depositors automatically share investment and default risk on the asset side. The bank is less likely to fall and a bank run is less probable. Owing to the different nature of banks’ assets and liabilities, an Islamic banking system would be more stable relative to conventional banking (Khan, 1986).

Another aspect of instability is related to the existence of an integrated debt market, which is one of the main institutional features of the conventional economic system. It has outgrown the real sector in size and reached a high degree of global integration. As manifested in the international financial crisis of 2007-2012, integrated debt markets are sources of both domestic financial instability and contagion.

In Islamic finance, debt is created through selling commodities on credit. Resulting debt instruments are negotiable only at face value. There is a credit market for each commodity in which the demand and the supply to buy it on credit determines its mark-up rate[13], resulting in fully segmented credit markets[14]. The absence of sudden and mass movements of funds as well as the absence of risk trading rule out instability and contagion.

A third source of stability is that Islamic finance, properly practiced, never provides present money in return for future money. All Islamic modes of finance involve money on the one end and commodities on the other[15]. Monetary flows and commodity flows through Islamic finance are directly tied together. The dichotomy between financial and real activities is effectively removed. Each instance of financing extended is automatically earmarked for specific uses, leaving no room for excessive credit expansion.

The fourth source of stability is the absence of debt- and risk-trading whereby changes in the supply of money by policymakers would automatically be translated into changes in excess demand and supplies of commodities. The quantities of output produced respond more quickly to market forces. Markets are therefore more likely to operate efficiently and smoothly. Though absolutely non-conventional, Islamic finance supports market forces and mechanisms more than does conventional finance.

Information asymmetry

The only contract used by conventional finance suffers from information asymmetry. Some Islamic finance contracts are also prone to information asymmetry. In particular, muḍārābah (restricted and unrestricted profit sharing venture), wakālah (restricted and unrestricted agency investment) and salām (contract of deferred delivery of commodities) suffer from information asymmetry. Setting those five contracts aside, the majority of Islamic finance contracts do not suffer from such malady.

Assuming no regulatory hindrances, Islamic banks, like universal banks, can carry out finance using a multiplicity of contracts. They would mix contracts that are free from information asymmetry with others suffering from it (the abovementioned five contracts). The process of contract mixing and matching, which is supposed to be central to the art of Islamic banking is called product structuring. Like universal banks, Islamic banks can therefore hold equity in the businesses they finance while supplying them with funds under muḍārābah, wakālah and salām, or any other contract. Such resemblance to universal banks enables them to better handle the problems of moral hazard and adverse selection than conventional (commercial) banks (Al-Jarhi, 2003).

Finance and development through operation as universal banks

As explained above, Islamic banks have to mimic some aspects of the behavior of universal banks to avoid the problem of information asymmetry.
Universal banking that combines all phases of finance has been credited in part for industrial development and economic growth in Germany and Japan. It has yielded economies of scope and greater efficiency that provided more finance at lower costs, thereby promoting industrial investment (Greenwood and Bruce, 1997; Vaona, 2005; Nyankomo and Zhanje, 2015). In particular, German banks have been perceived to maintain close, long-term relationships with industrial firms, which have influenced banks’ attitudes towards multi-period optimization. This opinion is supported by Temin (1998) but opposed by Fohlin (1998) as well as Miwa and Ramseyer (2000).[16]

Participation in management would also be effective in solving the lemon problem. Such participation affords Islamic banks free and continuous monitoring with a flow of information that helps make judgement regarding investment feasibility. Empirical findings confirm the role of universal banks in economic development. Calomiris (2000) found that universal banking was behind reducing the cost of financing industrialization in pre-First World War Germany relative to other countries with commercial banking. He also found that a higher level of allocative efficiency was enjoyed by the financial sector in the former than in the latter countries. It can therefore be concluded that Islamic banks operating as universal banks provide better support to economic development.

Fund mobilization
Many followers of religions that abhor interest (Hinduism, Buddhism, Judaism, Christianity and Islam) hold their funds outside the banking and financial sector, thereby placing some of their financial resources outside the development process. Islamic finance opens the door to mobilizing such resources, especially in many Islamic countries where they would otherwise be kept idle. Islamic financial products would be both interest-free and ethical[17]. This makes Islamic finance even more effective in resource mobilization to the groups of people interested in both avoidance of interest and exclusive involvement in ethical investment.

Adjustments to policy shocks
By going deeper into understanding the prohibition of interest, it is found that it is really the prohibition of trading present against future money at a premium. In other words, the prohibition of interest amounts exactly to the prohibition of nominal transactions (Al-Jarhi, 2016). The prohibition of *riba* (interest) can therefore be interpreted from the economic perspective as the prohibition of debt- and risk-trading.

In an economy with Islamic finance, when the supply of money increases, spending increases both directly and through the availability of more financing. In Islamic finance, both spending and finance are channeled exclusively through real transactions. Direct spending means direct cash flows to the commodity sector. Financing would also boost both supply and demand. The quantity and price speeds of adjustment get full throttle as no cash balances leak to nominal transactions. The transmission mechanism from monetary expansion to spending is direct. In such an economy, the speed of adjustment is swift and the market mechanism fully supported.

In contrast, a system with conventional finance faces substantial leakage from monetary expansion flows into nominal transactions, namely, debt- and risk-trading. The final effects on the commodity sector will not emerge until the payoff of gambling in the financial market reaches the pockets of winners. In addition, the first effect of the financing directed to the commodity sector would go to the demand side first. Price speed of adjustment would be higher while quantity speed of adjustment would lag...
behind. Inflation would be the ultimate result, even when the economy is below full employment.

Ultimately, with conventional finance, there are slower speeds of adjustment, biased toward price adjustments. The market mechanism would limp slowly to the new equilibrium, if ever reached.

It can be concluded that by prohibiting nominal transactions, Islamic finance boosts speeds of adjustment, as they would also be balanced between quantity and price speeds. The market mechanism is ultimately strengthened.

Systemic integrity
Risk is an important ingredient of investment. In conventional finance, investment is financed through equity (the stock market) or through debt (borrowing from banks and issuing bonds). Banks accept only collateral risk. They always avoid bearing business risks. Corporate bondholders follow the same rule and their debt carries seniority over shareholders’ rights. The result is that risk is left to be borne by a few specialists, who are either entrepreneurs or shareholders. Such a minority of risk bearers shoulder the brunt of investment failure. Although the per capita risk for the whole society may be low, risk concentration on a small group could be unbearable. The commodity sector would be far removed from the finance sector, as each goes its own way. In other words, the system would be disjointed.

Islamic banks and financial institutions share risk with those receiving finance. With proper corporate governance, depositors can influence banks’ investment decisions as they share in the decision-making process by having representatives on the boards of directors of Islamic banks. This change that we have proposed would extend risk as well as decision sharing to both the asset and liability sides of Islamic banks (Al-Jarhi, 2014).

In an economy with Islamic finance, both risk and decision-making are spread over a much larger number and wider variety of concerned people. Wider involvement in economic activities eventually leads people to feel that they are partners rather than spectators.

The benefit of wider involvement goes beyond a mere feeling. It adds to the stability of banks. The finance sector would be closely tied to the commodity sector. This affords the economic system compactness and integrity between its different parts.

Equity
Islamic banks, if given the right tools, can contribute to the society’s efforts to eradicate poverty. Zakāh can be perceived as a tax-subsidy approach to reducing poverty. It is paid out by those whose wealth exceeds a certain minimum level in proportion to their property or income.

Zakāh proceeds are for several uses including income and wealth maintenance for the poor. Income maintenance is provided provisionally to the poor until wealth maintenance is restored. Zakāh proceeds would be earmarked to finance micro projects whose titles are given to the poor. The Islamic approach to poverty reduction can be closely intertwined with that of economic development. Making the poor more productive through redistribution will ultimately contribute to economic development. Undoubtedly, zakāh management institutions must be structured and empowered to be able to fulfill such a mission.

Islamic banks can help by acting as custodians of zakāh proceeds and in their disbursement. Islamic banks are also mandated to have special accounts to which
shareholders’ zakāh on their equity is credited. They can even accept direct payments of zakāh and other donations on behalf of depositors and other donors. Banks can then use funds available in their zakāh accounts for the purposes of income and wealth maintenance of the poor.

The ability to repay loans attracts the utmost attention of conventional finance. The provisions of collateral and guarantees are major tools used to ascertain such ability. The wealthy have the most access to finance. In contrast, Islamic finance can be advanced on equity or PLS basis. It would give prime attention to profitability and less attention to collateral. Low net worth people with worthy investment projects would have more access to finance.

**Debt sustainability**

In conventional finance, debtors facing temporary insolvency would have severe problems in settling their debt. The amount of debt, not fixed from the start, multiplies as interest is calculated on the outstanding balance of debt; interest is also compounded annually and sometimes at shorter intervals. Penalty rates of interest are imposed on insolvent debtors, which are higher than regular rates. Borrowers often end up paying debt service many times more than the original principal they had borrowed without being able to settle their debt obligations, particularly in credit card and developing countries’ debt. Debt payment difficulties sometimes reach crisis levels. Debt relief through bankruptcy procedures and through developing countries appealing their cases to creditors’ clubs in London and Paris is often sought after.

Conventional debt generally lacks sustainability. That has been demonstrated repeatedly at times of crises, when attention is usually directed to bail out lenders (banks) and not borrowers.

Islamic finance creates debt that is more sustainable. The total value of debt, which includes the value of commodities purchased on credit as well as an implicit mark-up, is set from the very beginning.

Debtors may still face unavoidable circumstances making them temporarily insolvent. The Shari’ah mandates that financing banks grant them free rescheduling to help them bring their finances back to order. No penalty or rescheduling fees can be levied in this case[18].

Due to the information asymmetry associated with conventional finance, moral hazard leads to using borrowed funds for non-prescribed purposes, leading to default. In contrast, the greater ability of Islamic finance to avoid information asymmetry and moral hazard through mixing and matching among the numerous Islamic finance contracts, makes sure that the advanced funds are used only for their prescribed purposes. Default resulting from moral hazard would therefore be most unlikely.

**Reform agenda for conventional finance**

Conventional finance has shown exposure to instability and contagion. The latest international financial crisis was accompanied by widespread bank failure confronted by expensive bank bailouts, in addition to a serious recession that lingered for four years after the onset of the crisis. Some economists advanced reform proposals revolving around tighter regulation. Others suggested that capital movements should be curtailed. An interesting opinion goes back to the Chicago Plan submitted during the Great Depression.

The above analysis regarding Islamic finance contains a prescription to the problems of contemporary market economies in the following institutional changes:


Mixed systems hurdles

The above-mentioned advantages of Islamic finance appear to be externalities that accrue to the system as a whole but do not accrue directly to any Islamic bank or financial institution in particular. This creates an incentive problem; Islamic bankers would not be sufficiently motivated to follow the Islamic finance paradigm to the letter. The incentive problem can be solved through some method of internalizing the external benefits.

In mixed systems with the absence of any means of internalization, Islamic bankers have to compete with conventional bankers who use the classical loan contract, which is simpler, requiring fewer procedures and less documentation than the Islamic modes of finance. Following the Islamic finance paradigm strictly would lead to a serious competitive loss to Islamic banks and financial institutions.

To maintain a competitive edge, they maintain their nominal brand name and mimic conventional finance. This enables them to streamline procedures and documentation as well as cut down costs. This calls for special regulations to force Islamic banks to be true to their Islamic banking license. Without such regulations, Islamic finance will never be able to live up to its ideal (Al-Jarhi, 2014).

Conclusions and policy recommendations

Starting with certain macroeconomic, banking, price and finance theories, it is found that Islamic finance, when applied according to Al-Jarhi’s (1981) paradigm, would have distinct advantages. In addition, it provides a justifiable prescription for reforming the contemporary market economy. The fact that there is economic rationale for Islamic finance can therefore be accepted.

There is one important caveat to these results. The noteworthy advantages of Islamic finance are not sufficient to induce Islamic bankers to be true to the Islamic finance paradigm. Being mostly external, such advantages can induce behavior only after being internalized, which is left to banking and finance regulators. Only when the license of Islamic banking is strictly enforced by the monetary regulators will Islamic bankers avoid mimicking conventional finance.
Notes

1. This runs in contrast to the opinion of Naqvi (1977) who claims that the institution of interest helps achieve economic efficiency, but provides no proof.

2. If a supermarket were faced with an increase in interest rates, it would attempt to collect cash faster from its tellers and rush it more often to the bank, using more labor (people who collect cash as well as security guards) and capital (armored cars). Obviously, the withdrawal of real resources from production into transactions reduces total output and efficiency (Al-Jarhi, 2016).

3. This quotation shows that what is intended is not to impose a zero rate of interest on the national economy, but to reach the desired level through the process of deflation.

4. Economists also recommended the application of 100 per cent required reserve ratio. However, policymakers have not been impressed, despite the obvious benefits.

5. Universal banks are defined as “large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters” (Calomiris, 2000).

6. When both counter-values are deferred, market authorities set safeguards to ensure that both parties to the gamble will pay their obligations.

7. The phenomenon of financialization, which has led to the financial sector dwarfing the real sector, would mean that only a small part of monetary expansion would trickle down to the real sector, rendering monetary policy ineffective.

8. Some might think that the way to establish an interest-free economy is to exclusively use qard hasan (interest-free loans) to finance economic activities. Such loans are usually considered as charity and would not suit business finance. Others think that a cashless society would fulfill the objectives of Islamic finance. However, a cashless society still has money in a non-physical form which can be created and allocated on the basis of interest.

9. Private foundations are considered to be perpetual after-life charities that earn rewards from God while their founders are dead. That is why Muslims have been keen to establish them. In the past, most health and education services were provided through private foundations.

10. Although such a rule can be deducted from both Samuelson’s and Friedman’s analysis, the rule is exclusively Friedman’s.

11. Of course, the fact that Islamic finance suffers from malpractice and serious excesses cannot be hidden. This however is a problem that requires explanation.

12. The classical loan contract, in the case of deposits, mandates that banks guarantee both principal and interest. However, this should not be interpreted as a guarantee against bank default.

13. The mark-up rate is the difference between the spot price and the deferred price as a percentage of the spot price.

14. Debt can be swapped against tangible goods or services (according to Imam Malik and Ibn Taymiah), but not for cash.

15. This meaning includes all sale finance. Partnership and investment agency finance can be considered as money advanced for shares in future income resulting from commodity-related activities.

16. Much of the doubt about the role of universal banking centers around the issue of governance. Those who claim that universal banks take part in the management of the firms they finance, credit universal banks with an important role in economic development. Those who doubt that participation takes place to any effective extent take the opposite position. Equity participation in Islamic finance prescribes effective participation in management. This would settle the issue.
17. One cannot help but notice that the word “Islamic” in this context could have two meanings. The first refers to the quality of the financial product, namely, that it satisfies the Islamic requirements for lawful contracts. The second is that it satisfies ethical standards as defined by religion. In the latter sense, Islamic finance would equally be attractive to Christians, Jews, Buddhists and Hindus.

18. During the international financial crisis, had the authorities directed their attention to support debtors instead of creditors, the crisis would have stopped without an ensuing serious depression. However, this particular part of Islamic finance cannot be expected to be implemented without strict and well-enforced regulations.

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Further reading

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CSR practices of Palestinian Islamic banks: contribution to socio-economic development

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Abstract

Purpose – Corporate social responsibility (CSR) is an important corporate activity that affirms the importance of giving back to the community. This research aims to examine the CSR practices of Palestinian Islamic banks and their contribution to socio-economic development. There is an ongoing debate regarding Islamic financial institutions’ profit motive versus their motivation to achieve human welfare. The Palestinian Islamic banks are not disconnected from this debate, and this paper aims to discuss this issue.

Design/methodology/approach – For the purpose of assessing the CSR practices of Palestinian Islamic banks, a secondary analysis of the banks’ annual reports was carried out. In addition, 11 structured interviews were conducted with Islamic banks’ practitioners at the decision-making level and with some of the banks’ Shariah board members to gather their views on CSR. These have been analyzed in light of the actual CSR practices disclosed in each bank’s annual reports.

Findings – The main research findings suggest that the CSR practice is highly valued by the Palestinian Islamic banks, but it is small and has marginal effects on the community’s socio-economic development. Another important observation from report analysis is that Islamic banks have great potential for expansion, given that the demand for Islamic financial transactions is double of what Islamic banks currently offer. If Islamic banks live up to that opportunity, they could deliver more in CSR practices, which is their ultimate goal according to the majority of the interviewees.

Originality/value – Existing literature has presented findings on the CSR of Palestinian corporations in general, but there is no available literature on the CSR practices of Palestinian Islamic banks. This research attempts to fill in the gap by presenting preliminary findings on Palestinian Islamic banks’ CSR practices.

Keywords Islam, corporate social responsibility, community development, Palestinian Islamic banks, Shariah objectives, socio-economic development

Paper type Research paper

Introduction

Corporate social responsibility (CSR) is an important practice carried out by most of the large corporations in the world. CSR practices by corporations towards the communities they operate in are of great importance for the continuing development of the corporations regardless of the sector they operate in. Banks are one of the key components of the modern economic system, playing an essential role in the economic development of societies. Islamic banks, which were initially developed in Muslim-majority countries, have today expanded...
beyond Muslim borders. They are attractive to both conservative Muslim populations who consider the Islamic financial system as a financial alternative and to non-Muslims who want to explore the products and services of Islamic banking and finance.

CSR has become a fundamental pillar in the practices of banking and financial institutions. More pressure tends to fall upon Islamic banks to engage in social financing. One way that Islamic banks address the issue is by increasing their CSR practices. By doing so, they reduce the criticism that Islamic banks fail to achieve the main economic objective of Islam, which is improving human well-being, while focusing on profit sharing and risk management (Heles and Migdad, 2005; Asutay, 2007, Farooq, 2009). Islamic banks generally do not have a unified CSR framework to follow. That is certainly the case in Palestine and seems to hold true for other Islamic banks as well, some from the leading global hubs of Islamic finance and banking (Jusoh and Ibrahim, 2015).

The focus on banks is because they represent the largest financial institutions in the country. The bigger picture of human security protection in Palestine requires larger efforts that must include external players because of those countries’ sensitivity and the long-lasting Israeli occupation. However, focusing only on Islamic banks’ CSR practices makes it possible to draw relevant conclusions on the banks’ role in socio-economic development. Furthermore, CSR is always mentioned in the annual reports of Palestinian Islamic banks, and the institutions’ practices in that field are clearly pointed out and well elaborated based on the importance of giving back to the community.

In this paper, the practitioners’ perspectives on Palestinian Islamic banks’ CSR practices are investigated. There are four Islamic banks in Palestine. Three of them make their annual reports available to the public, while one bank does not. The banks differ in the ways they report their CSR practices. Not only that, they appear to have different perceptions of what CSR is.

In addition to the introduction, this paper is structured to cover:
- a review of previous studies;
- explanation of the research methodology;
- discussion of Palestinian Islamic banks’ CSR based on an analysis of Islamic banks’ annual reports;
- the perspective of Palestinian Islamic banks’ practitioners on CSR and their contribution to socio-economic development; and
- the conclusion.

Background and review of previous studies

Overview of Islamic banking in Palestine

Following the establishment of the Palestinian National Authority (PNA) in 1994, a number of financial institutions were established, mainly banks. Several commercial, Islamic and specialized banks comprise the foundation of the banking system in Palestine. There are four Islamic banks in Palestine, two of which operate in the Gaza Strip and the West Bank, while the other two operate only in the Gaza Strip. Two of these banks are recognized by the PNA, while the other two are not, for reasons associated with rivalry and conflict between political parties. However, all four banks are active in the country and have an effect on local Palestinian socio-economic development. Therefore, all four banks are studied in this paper.

Islamic banks in Palestine have continued to grow despite the unfavourable economic system and the unsupportive policies of PNA towards the newly established Islamic banks. This indicates that there has been continuous demand for the services of Islamic banks and
financial institutions. The proportion of Islamic banking transactions is less than 9 per cent of the total banking sector in Palestine, and the estimated demand for Islamic banking services is 20 per cent (PIF, 2014, p. 42).

There is still no regulatory framework in Palestine that governs Islamic banks’ activities separately from conventional transactions. The Palestinian Principal Law, enforced in 2002, is based loosely on the Sharīʿah (Islamic law). However, the banking system is a combination of both conventional and Islamic modes of financing. Sharīʿah-compliant financial transactions, as all other financial activities, are governed by the same legislation which is regulated by the Palestinian Monetary Authority (PMA), notably the Law of Jordan of 1966 and the PMA Law of 1997. In the Palestinian context, the PMA is an independent public institution responsible for monetary and banking policies.

Islamic financial institutions that operate in Palestine count on the Muslim population’s desire to live a halāl (Islamically permissible) life where investment, banking and insurance are all Sharīʿah-compliant. One of the awareness sessions on the work of Islamic financial institutions in Palestine connected a “relieved life” with “banking and insurance being halāl”. It was also stressed that when the Islamic alternative is available, it has to be chosen over any other alternative. In Palestine, literacy rates and the understanding of Islamic teachings are relatively high. Palestinians understand the importance of Sharīʿah compliance, and their demand for Islamic banking services is higher than what Islamic banks can currently offer (PIF, 2014). This is partly the reason why Islamic financial institutions are growing despite all odds.

The importance of Islamic banking services in Palestine
Roy (1999) and More (2008) describe how the Palestinian living conditions have been gradually deteriorating despite the high level of international support since Oslo 1945. One of the problems concerns “Palestinian capitalists”. The governments of high-risk countries and those at conflict are generally repressive regimes that exercise “narrow development”. This causes further conflict because the elites (in the Palestinian case, they are called Palestinian capitalists) use the wealth of the country to finance family businesses and incur private accumulations by taking advantage of the weak financial system (Addison et al., 2001, p. 3).

Abdel-Shafi (2015, pp. 16-25) describes the Palestinian economy as a “myth” and highlights the importance of cooperating with civil society institutions and private financial institutions to direct funds where they are necessary. The relevance of the development of Islamic banks is that they serve the purpose of financially including large numbers of Palestinians across the country, especially those that reject conventional financial institutions. They also exist as important financial institutions with large pools of savings and thus represent great investment ability (Heles and Migdad, 2005).

However, Islamic banks’ investment ability is currently relatively poor, especially in the Gaza Strip. The 11-year siege imposed there targets the economy and people’s livelihoods for political reasons, resulting in great economic and social insecurity in people’s lives. However, despite the Islamic banks’ current limited ability, their role theoretically remains very important in elevating social and economic insecurities. To this end, Islamic banks are important because the PNA has failed to present itself as a capable service provider on most levels (More, 2008). The Palestinian demand for Islamic banks services is at least twice as much as the banks can currently provide (PIF, 2014). Finally, the philosophy upon which Islamic banks are built is best suited to elevate social and economic development in Palestine.
Recognizing the importance of corporate social responsibility

CSR has become an irreversible part of the corporate and business life in all sectors. The practices of CSR revolve around ethics, social development and environmental protection, among other issues (Dusuki, 2008; Chintaman, 2014). However, in every region and in every community where a corporation works, CSR practices are implemented to meet the local social needs, which brings greater value to the corporation. Thus, all types of businesses carry out CSR initiatives for many reasons, including furthering their relationships with their customers, employees and community. Islamic financial institutions are not inresponsive to this strategy, given they are also business entities (Jusoh and Ibrahim, 2015).

Bolanle et al. (2012), studying the First Bank of Nigeria, found a positive relationship between CSR and the bank’s profitability. A much broader study of 90 different Islamic banks in 13 different countries also found a positive relationship between CSR and financial performance (Mallin et al., 2014). The study also found a positive and highly significant association between the size of the Shari’ah supervisory board and the CSR disclosure index (Mallin et al., 2014).

A number of studies have highlighted the importance of social development in Islam and advocated an active role for Islamic financial institutions in that process. For example, Islamic financial institutions are said to “provide social and community finance to socially vulnerable groups and reinforce social cohesion” (Sairally, 2007). Asutay (2007, p. 189) described Islamic finance as being concerned with human justice and human-centred economic growth and development. El-Gamal (2006) and Farooq (2009) also shared similar ideas about the importance of social and community development being part of the Islamic finance industry agenda. Farooq (2009) noted that Islamic financial institutions must not be left to operate for the sole purpose of profit. This is in consideration of the importance of adhering to the main objective of Shari’ah in economics, which is human well-being.

A significant number of studies have focused on Islamic banks’ CSR in particular geographical locations, including Malaysia, the Gulf countries and Bangladesh, among others. For instance, Chintaman (2014) covered banks in the Gulf Cooperation Council region, Jusoh and Ibrahim (2015) studied all Malaysian Islamic banks. Rashid et al. (2013) conducted a study focusing on Islamic banks’ ethical efficiency in Bangladesh taking into account customer-centric CSR. Mallin et al. (2014) expanded their domain of their inquiry to the CSR activities of 90 Islamic banks across 13 countries. The main outcome of these studies is that CSR is not a new practice in Islamic banks or in the Islamic finance industry in general. Furthermore, those studies described the social responsibility of Islamic financial institutions as a religious obligation.

A few studies on the CSR of Islamic banks and Islamic financial institutions focused on the assessment of CSR according to Islamic values (Dusuki, 2008; Tafti et al., 2012; Basha and Yusuf, 2013). Asutay (2007), Sairally (2007) and Farooq (2009) have all emphasized the importance of rethinking the status of Islamic banks and their adherence to the main objectives of Shari’ah in economics. Sairally (2013) evaluated the corporate social performance of Islamic financial institutions. Hassan and Harahap (2010) further discussed CSR disclosure by Islamic banks. This is important because Palestinian Islamic banks have widely differing views of what constitutes CSR, which is reflected in the ways they disclose it in their annual reports.

Jusoh et al. (2015) found that Malaysian practitioners thought a framework ought to be established for CSR of Islamic banks in Malaysia. The authors then attempted to provide such a framework. Farook (2007) proposed a structured definition of the social purpose of Islamic financial institutions fulfilling a collective religious obligation. Perhaps the most
systematic effort in this regards was that of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which introduced a governance standard for Islamic financial institutions on CSR conduct and disclosure (AAOIFI, 2015).

In Palestine, responsibility towards the society is a very important concept. Similar to other countries, Palestinian corporations, especially the largest businesses in the country, engage in CSR practices. However, the literature on CSR in Palestine is very minimal. One research measured the perception of Palestinian corporations with regards to CSR practices. In this research, CSR was found to be moderate for two main reasons:

1. difficulties in implementation; and
2. under-reporting of CSR practices (Alsenawi and Banat, 2014).

Another research that examined the effect of CSR on the profitability of all banks working in Palestine found that donations had significance on returns on assets, and the paper concluded that banks in Palestine should focus more on financially contributing to social issues (Sabri and Sweis, 2016). Literature on Islamic banks’ CSR practices was, however, not found. This study thus pioneers the literature on Islamic banks’ CSR in Palestine. The study analyzes the banks’ CSR practices as disclosed in their annual reports and presents new knowledge on the perception of practitioners and Sharī’ah board members regarding their banks’ CSR practices.

Research methodology
This study is qualitative in nature. It uses two methodological approaches. The first is a secondary analysis of the published annual reports of the four Islamic banks that operate in Gaza and the West Bank. Only three of the banks made their latest 2015 report available (Palestine Islamic Bank [PIB], Arab Islamic Bank [AIB] and Islamic National Bank [INB]). Thus, the disclosure of the three Islamic banks’ CSR practices in their annual reports was analyzed to see how the perception of the banks’ practitioners corresponds to what the banks actually practice.

The second approach used in this research was a structured interview with six practitioners at a decision-making level and five members of the banks’ Sharī’ah advisory boards. Interview questions were made short and clear, given that it was an e-mail-based interview. Simplicity and clarity guarantee higher accuracy and a satisfying outcome (Denscombe, 2014). The majority of the percentages reported in this paper are calculated based on frequencies from interviews, unless otherwise indicated.

The importance of taking a qualitative approach to achieving the objective of this study is owing to the relative difficulty of measuring the objective via quantitative numerical analysis. For example, Islamic economists appear to have used ratio analysis and various input and output frontier models in measuring the efficiency of Islamic banks, such as the ratio method, econometric models and efficiency models. However, the way they have used the technique often has gaps, errors and inconsistencies that render their conclusions vulnerable even within their own framework (Hasan, 2004).

The performance of Islamic financial institutions ought to be evaluated in reference to social responsibility in an Islamic framework (Hasan, 2004). As such, finding reliable research conclusions on Islamic banks’ CSR practices is more likely to be achieved through qualitative research methods. In the last section of this paper, when discussing the perspectives of Palestinian Islamic banks’ practitioners and Sharī’ah board members, the percentages are provided according to repetitions of certain responses to each of the interview questions.
Palestinian Islamic banks’ corporate social responsibility: perspective and practice

The CSR of Islamic banks needs to be understood in the broader context of the Palestinian economy and Palestinian Islamic banks’ financial representation within the Palestinian community. To that end, deposits in all Palestinian banks and then deposits in Islamic banks are briefly reviewed for comparison with the value of CSR practices. First, the status of all banks will be reported, and then the status of Islamic banks. Finally, in this section, the value of each bank’s CSR will be put into the larger context of each bank’s financial capacity.

The current status of all banks in Palestine

According to the PMA, the number of banks that operate in Palestine as of 2015 is 16. This does not include the Islamic National Bank (INB) and the Palestinian Production Bank (PPB) that operate in Gaza and are not yet recognized by the PMA. Among the 16 banks are two Islamic banks: Palestine Islamic Bank (PIB) and the Arab Islamic Bank (AIB). The two banks have a total of 33 branches between them spread throughout the most active cities in the West Bank and the Gaza Strip. Although the deposits in the Palestinian banks altogether reached US$9.7bn as at 2015 (PMA, 2015), they have failed to provide necessary facilities to finance long-term development in particular.

Investment in Palestine involves high risk; therefore, the majority of investment carried out by Islamic banks is in the form of *murābaha*. The *murābaha* contract used by Islamic banks guarantees returns on investment. By analyzing the Islamic banks’ annual reports, the researcher finds that the majority of *murābaha* contracts relate to personal financing and represent on average about 90 per cent of the banks’ investment. Personal financing in Palestine is largely used for cars and houses, rarely for businesses. Table I exhibits the percentage of annual change in credit facilities provided by all Palestinian banks, including Islamic banks.

Status of Islamic banks in Palestine

The share of Islamic banking in Palestine was about 12 per cent in 2015 (AIB, 2015). Taking into consideration that the demand for Islamic banking transactions is about double the banks’ capacity (PIF, 2014, p. 42), there is an opportunity for Palestinian Islamic banks to significantly increase their market share.

There are four Islamic banks that operate in Palestine. Two were established with the establishment of the PNA. After that, two other banks were established; however, they were not recognized by the PNA. Table II shows the banks’ year of establishment, the number of branches and their official status.

<table>
<thead>
<tr>
<th>Year</th>
<th>Deposits (USD million)</th>
<th>Change in deposits (%)</th>
<th>Credit facilities (USD million)</th>
<th>Change in credit facilities (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>6,802.4</td>
<td>–</td>
<td>2,885.9</td>
<td>–</td>
</tr>
<tr>
<td>2011</td>
<td>6,972.5</td>
<td>2.5</td>
<td>3,552.6</td>
<td>23.0</td>
</tr>
<tr>
<td>2012</td>
<td>7,484.1</td>
<td>7.3</td>
<td>4,199.3</td>
<td>18.0</td>
</tr>
<tr>
<td>2013</td>
<td>8,303.7</td>
<td>11.0</td>
<td>4,480.1</td>
<td>6.6</td>
</tr>
<tr>
<td>2014</td>
<td>8,934.5</td>
<td>7.6</td>
<td>4,895.1</td>
<td>9.2</td>
</tr>
<tr>
<td>2015</td>
<td>9,654.6</td>
<td>8.1</td>
<td>5,824.7</td>
<td>19.0</td>
</tr>
<tr>
<td>2016Q1</td>
<td>10,054.7</td>
<td>4.1</td>
<td>6,137.3</td>
<td>5.3</td>
</tr>
</tbody>
</table>

**Table I.** Customer deposits in Palestinian banks (USD million)

**Source:** PMA (2016)
The Palestinian Islamic banks have some limited economic contributions. Table III shows the increase in deposits in the Palestinian Islamic banks from 2014 to 2015. Islamic banks rely heavily on individual deposits managed under current accounts to expand their operations and participate in local economic activities. According to Sabri and Sweis (2016), Palestinian banks’ donations in the form of CSR practices increase the profitability of the banks they examined, which included the two main Islamic banks that operate in Palestine. To put the amount of money spent on CSR into perspective, each of the bank’s accounts is exhibited in Table III.

Usually CSR practices are financed from the corporation’s annual profit. However, in the case of the INB, the actual donations that could be categorized as CSR practices were not disclosed in the report, but rather a few of the rather socially responsible Islamic contracts (loans) were put under the CSR section, as will be explained later. PIB, for instance, makes use of *qard hasan* to finance its CSR initiatives. It stood at US $2.1m in 2014 and US$2m in 2015 (PIB, 2015). The majority of Islamic finance transactions conducted by Palestinian Islamic banks use the *murābahah* contract, which tends to be low-risk and offers a highly guaranteed return. It is the reason why this contract represents the majority (about 87 to 96 per cent) of investment in direct credit facilities given by each bank in 2014 and 2015 (AIB, 2014, 2015; INB, 2014, 2015; PIB, 2015).

**Palestinian Islamic banks’ corporate social responsibility practices**

In this section, each of the Islamic bank’s CSR practices is exhibited to show the different fields that receive donations in the form of CSR. Health, education, the environment and cultural activities were the main CSR activities carried out by the banks. In Palestine, relief aid is always present, due mainly to the continued Israeli aggression. Table IV shows the CSR activities of PIB and AIB, which reflect a high level of similarity in their CSR activities, though it should be emphasized that they had radically different distributions between the

### Table II.

Islamic banks that operate in Palestine as at 2016

<table>
<thead>
<tr>
<th>No.</th>
<th>Bank</th>
<th>No. of branches</th>
<th>Year established</th>
<th>Official status</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>PIB</td>
<td>21</td>
<td>1995</td>
<td>Recognized</td>
</tr>
<tr>
<td>2</td>
<td>AIB</td>
<td>11</td>
<td>1995</td>
<td>Recognized</td>
</tr>
<tr>
<td>3</td>
<td>INB</td>
<td>4</td>
<td>2008</td>
<td>Not recognized</td>
</tr>
<tr>
<td>4</td>
<td>PPB</td>
<td>1</td>
<td>2013</td>
<td>Not recognized</td>
</tr>
</tbody>
</table>

**Source:** Palestinian Islamic banks annual reports 2016

<table>
<thead>
<tr>
<th>Bank</th>
<th>Current accounts</th>
<th>General investment deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2015</td>
</tr>
<tr>
<td>PIB</td>
<td>134.4</td>
<td>154.9</td>
</tr>
<tr>
<td>AIB</td>
<td>134.3</td>
<td>158.2</td>
</tr>
<tr>
<td>INB</td>
<td>29.7</td>
<td>31.7</td>
</tr>
<tr>
<td>Total</td>
<td>297.7</td>
<td>344.8</td>
</tr>
</tbody>
</table>

**Source:** Palestinian Islamic banks annual reports 2016
various areas. However, the data in the table indicate that there is no specific plan. The total amount spent by AIB was US$445,235 in 2015. It was right after the 2014 Israeli aggression, but expenditure on relief and health was rather low compared to expenditure on cultural activities. PIB spent about 450 times more on relief and health than it did on cultural activities in 2015, whereas the AIB spent much more on cultural activities during the same year.

The CSR activities of INB are separately provided in Table V, because of the large differences in their activities. The annual report of INB only recognizes the importance of CSR practices and mentions their engagement and support for a few cultural and community events without specifying the value of contribution. On the other hand, it is noted that the bank provides a significant amount of loans that have an effect on local socio-economic development. These include giving loans for marriage and microfinancing. It is not clear whether the bank actually confuses CSR practices for loans that have a social impact, or their intention was to consider loans as part of their CSR practices.

In terms of CSR expenditure as a percentage of profit after tax, the annual reports of PIB and AIB show 7.42 and 8.56 per cent, respectively, as provided in Table VI. It was however not possible to calculate the percentage that CSR expenditure represents out of profit for INB, as their disclosure of what CSR is was not clearly mentioned and in some events only the description of the CSR practice was available without clarifying the value.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Development</td>
<td>3,000</td>
<td>13,000</td>
<td>30,774</td>
<td>11,600</td>
</tr>
<tr>
<td>Relief</td>
<td>440,487</td>
<td></td>
<td>25,470</td>
<td>17,556</td>
</tr>
<tr>
<td>Education</td>
<td>96,751</td>
<td>60,000</td>
<td>39,484</td>
<td>18,149</td>
</tr>
<tr>
<td>Children</td>
<td>2,150</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cultural activities</td>
<td>1,292</td>
<td>36,500</td>
<td>187,187</td>
<td>4,450</td>
</tr>
<tr>
<td>Health</td>
<td>143,030</td>
<td></td>
<td>28,269</td>
<td>62,254</td>
</tr>
<tr>
<td>Sports</td>
<td>4,850</td>
<td></td>
<td>38,104</td>
<td></td>
</tr>
<tr>
<td>Environment</td>
<td>15,576</td>
<td>802</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special needs assistance</td>
<td>7,998</td>
<td></td>
<td></td>
<td>4,125</td>
</tr>
<tr>
<td>Humanitarian emergencies</td>
<td></td>
<td>9,142</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building mosques</td>
<td></td>
<td>124,107</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>29,556</td>
<td>690,496*</td>
<td></td>
<td>148,129</td>
</tr>
<tr>
<td>Total</td>
<td>744,690</td>
<td>799,996</td>
<td>445,235</td>
<td>304,367</td>
</tr>
</tbody>
</table>

Note: *This number is distributed in health, sport and other activities but not specified
Source: PIB and AIB 2015 and 2016 annual reports (PIB, 2017; AIB, 2017)

<table>
<thead>
<tr>
<th>Loans categories</th>
<th>Loan amount</th>
<th>Beneficiaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marriage loans</td>
<td>3,187,000</td>
<td>1,594</td>
</tr>
<tr>
<td>Microfinance loans</td>
<td>4,554,390</td>
<td>720</td>
</tr>
<tr>
<td>Total</td>
<td>7,741,390</td>
<td>2,314</td>
</tr>
</tbody>
</table>

Table V. INB disclosed CSR practices 2015 (USD)
Source: INB (2015)
Overall, it appears that Islamic banks in Palestine have no specific strategic approach or methodology for CSR, nor do they have a unified plan for implementing CSR practices. However, the banks tend to recognize its necessity and therefore engage in projects and activities that benefit the community. Each Islamic bank has its own procedures through which it engages in CSR but not a fixed plan. Thus, each bank’s CSR practices change with changes in the bank’s strategic plan.

**Practitioners’ perception on corporate social responsibility and value to socio-economic development**

In this section of the paper, five main dimensions are discussed as reported by the six practitioners in decision-making positions and five Shari’ah advisory board members at Palestinian Islamic banks who were interviewed. The practitioners included a treasurer, a public relations officer, two officers from finance departments, a customer services officer and a senior bank manager. The questions were designed to reflect on the bankers’ and scholars’ perception of CSR and how these perceptions are reflected in the banks’ annual reports. The questions were related to:

- CSR as perceived by most Islamic banks;
- reasons driving your bank to engage in CSR practices;
- opinion on a unified CSR system for all Palestinian Islamic banks;
- the presence of a CSR plan or system at your bank; and
- the contribution of CSR to socio-economic security dimensions.

**Corporate social responsibility as perceived by most Islamic banks**

According to the interviewees, as reflected in Figure 1, CSR is about participating in community activities by sponsoring and financing health, education, cultural and sports activities. Additionally, it is viewed as a moral and ethical theory, an obligation towards the community that is voluntarily implemented to improve social and living conditions. Furthermore, some perceive it as development, precisely economic development to achieve a balance between a country’s economic policy and a decent life and a balance between the development of economic policy and the environment. The intention here is not to provide a clear concept of what CSR is. Rather, the aim is to show the general perception held by practitioners, which is that CSR is about helping people and contributing towards uplifting different dimensions of life.

**Reasons driving your bank to engage in corporate social responsibility practices**

Figure 2 explains the reasons for banks to involve in CSR activities. According to the respondents, their banks involve in CSR because they want to be partners in

<table>
<thead>
<tr>
<th>Bank</th>
<th>Annual Profit</th>
<th>CSR Practice</th>
<th>CSR % of Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIB</td>
<td>10,033,817</td>
<td>744,690</td>
<td>7.42</td>
</tr>
<tr>
<td>AIB</td>
<td>5,200,000</td>
<td>445,235</td>
<td>8.56</td>
</tr>
<tr>
<td>INB</td>
<td>1,782,696</td>
<td>N.A.</td>
<td>–</td>
</tr>
</tbody>
</table>

**Source:** Annual reports 2015 of PIB, AIB and INB

---

**Table VI.**
Palestinian Islamic banks CSR practices for 2015 (million USD)
development and because it is a religious obligation. The other main reasons behind engaging in CSR activities are mostly business-oriented and pragmatic. For instance, if there is enough profit, the bank engages in CSR; if a proposal is convincing and the beneficiary is a promising future partner, the activity takes place. Additional reasons are to achieve the bank’s goals, increase the value of the bank’s name and secure enough media coverage.

Opinion on a unified corporate social responsibility system for all Palestinian Islamic banks

Table VII shows the respondents’ views on a unified CSR system for the Islamic banks in Palestine. The justifications provided under each view are listed according to the importance attributed by the respondents and how frequently each justification was reported. However, with regards to the presence of a clear unified system for all the banks, it does not exist in practice, nor does a unified CSR system exist for Islamic banks. Each bank has a general process for accepting proposals from community organizations or individuals that can fall under CSR. However, no fixed plan exists, and CSR is subject to changes in each bank’s larger strategic plan and according to annual profits.
The idea of a unified CSR system found acceptance, where Table VII shows that 62 per cent of the respondents supported the idea. However, those that saw CSR as better off left un-unified (38 per cent) seem to have strong justifications. Nonetheless, both groups explained that the main purpose was to broaden CSR so that it reaches more people and has a bigger effect on the community. On the one hand, a unified CSR system would make banks more transparent and more committed and would help standardization and eliminate randomness. Unified efforts would also bring more recognizable outcomes. On the other hand, and rightly so, CSR is basically a voluntary charity. The voluntary nature of CSR is its main source of power. Some bankers explained that making it compulsory would strip away its source of power. Another reason for leaving CSR un-unified is that unification could unintentionally neglect some important needs of marginalized communities and that different banks operate in different local communities and could have different priorities.

The presence of a corporate social responsibility plan or system at your bank
Each of the Islamic banks in Palestine has a general strategy for CSR activities that changes with the bank’s bigger strategy. There is no specific fixed plan for any of the banks. However, according to the respondents’ feedback, 50 per cent confirmed that their bank had a plan for CSR activities, and the other 50 per cent explained that there is a general framework that is flexible and adaptable but nothing fixed and committed. Despite individual differences in elaborating on whether their bank has a set plan for conducting CSR activities or not, the end result is that each Islamic bank in Palestine has a general framework through which it conducts CSR activities.

Among the general comments in this regard were that the CSR practices change with the bank’s strategic plan and that CSR activities are planned for but in a limited way. Others who indicated that their bank has a plan explained that the plan is “providing financial support to localities and providing training opportunities for graduates”, “financing SMEs and productive projects” or “there is a seven-step process through which the bank engages in CSR”. However, all that is mentioned is either an activity or a process through which an activity is implemented.

The contribution of corporate social responsibility to socio-economic security dimensions
Both the social and economic settings in the Palestinian context are strictly connected to the political atmosphere: steady socio-economic development is achieved at a time of positive political atmosphere. In other words, socio-economic development in Palestine is fluctuating and dependent upon the political scene. For this precise reason, Palestinian Islamic banks are found to be operating using the least risky financial contract, Table VII. Opinion on introducing a unified CSR system

<table>
<thead>
<tr>
<th>It is a good idea: 62%</th>
<th>It is best left un-unified: 38%</th>
</tr>
</thead>
<tbody>
<tr>
<td>It makes banks more committed and transparent</td>
<td>Difficult, as different banks have different priorities</td>
</tr>
<tr>
<td>All banks participate in CSR as a unit, which has greater effects on community development</td>
<td>Unification could unintentionally lead to neglecting some important parts and needs of marginalized communities</td>
</tr>
<tr>
<td>A unified system must be obligatory but have some flexibility</td>
<td>The power of CSR comes from its voluntary nature; making it compulsory will make it weaker</td>
</tr>
<tr>
<td>It helps in achieving standardization instead of adopting a random policy</td>
<td></td>
</tr>
</tbody>
</table>

Table VII. Opinion on introducing a unified CSR system
murābahah, comprising an average of 90 per cent of total investments made within a year (Migdad, 2017, p. 86).

The fluctuations of politics cause many insecurities in the economic and social life of Palestinians. Insecurities in the Palestinian community tend to affect most dimensions of life for the majority of the people. Unemployment is high, poverty is high, trade is highly restricted, borders are mostly closed and the Gaza Strip has been besieged for its 11th year. All these economic insecurities cause additional social insecurities. One example is shortages in housing faced by new families.

There are three main factors recognized by bank practitioners and Sharī‘ah board members on the aspect of socio-economic insecurities. The first is that Islamic bankers and Sharī‘ah board scholars, who are among the intellectuals of the community, recognize the presence of such social and economic insecurities that range from marriage and family matters to unemployment and a deteriorating economic situation. The second important factor was the importance of giving back to the community and being part of the development process, as well as supporting the government in fulfilling its obligations towards satisfying the people’s needs. A third important factor is the limited ability of Islamic banks that remains at a margin of the whole Palestinian economy, which in turn suffers numerous problems.

**Conclusion**

In conclusion, Palestinian Islamic banks are developing and can further maximized their market share because the demand for Islamic financial transactions is higher than the actual supply. One important factor that can help in maximizing market share is to re-assure customers that Islamic banks are there to serve and achieve the objectives of Islam in their operations. One way that Islamic banks could achieve this is by maximizing CSR practices and making those practices more visible and connected to the community.

There is a positive relationship between banks’ profitability and CSR spending. Palestinian Islamic banks recognize that and work towards more involvement in CSR activities while also recognizing their institution’s limited ability in contributing more towards CSR. They are also willing to continue in that direction to build a better relationship with their customers and establish the name of the bank as a trademark.

One important point highlighted by the practitioners interviewed was the importance of doing what is best for business and that involvement in CSR represented doing what is best for business. In addition, CSR was also perceived as a religious obligation. As for the Sharī‘ah board members, they talked about what best satisfies the purpose and objectives of Sharī‘ah. The point was clearly made that one of the reasons CSR is practised is because of Islamic and ethical values. Like bank practitioners, Sharī‘ah board members did not neglect the banks’ business interests, but they prioritized religious objectives. Another important point that was highlighted was that CSR is practised if there is a convincing project proposal and high profits to cover the expenses. This point was stressed more by the bankers and not by the Sharī‘ah board members.

Finally, there was a rather positive response from the interviewees to making CSR practices unified, but both those who opposed the idea and those who accepted it conceded that the final goal is for CSR to maximize benefits to the community. Despite the value of standardization and the creation of a unified system, those who saw greater value in leaving CSR practices free from rules and systemic applications had a sound argument. The strength of CSR comes from its voluntary nature; making it compulsory in any way will make this voluntary giving grow weaker. Overall, the general outcome of this paper
confirms that the approach of Palestinian Islamic banks towards CSR is in line with the Islamic worldview and the objective of economic activities in Islam, which is to uplift human well-being.

References


**Further reading**


**About the author**

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The concept and application of ُ’daman al-milikiyyah (ownership risk)

Islamic law of contract perspective

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Muhammad Nabil Saupi
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Abstract

Purpose – The purpose of this paper is to elucidate the concept of ُ’daman al-milikiyyah (ownership risk) and to assess its application in contemporary Islamic financial products and services.

Design/methodology/approach – The methodology adopted is that of descriptive research.

Findings – From an Islamic law of contract perspective, the concept of ُ’daman al-milikiyyah is central to legitimate profit-making transactions and hence must be adhered to in practical applications of Islamic finance.

Research limitations/implications – This study should help motivate further investigation into the position of ُ’daman al-milikiyyah among different parties in existing Islamic financial products and services.

Practical implications – Policymakers and regulators should ensure that Islamic financial products and services are structured in a way that does not allow parties to profit without adequately bearing the liability for potential loss.

Social implications – The condition of ُ’daman al-milikiyyah as a source of legitimate profit reflects the idea that the role of finance in Islam is to promote and ensure social benefits.

Originality/value – This paper emphasizes the importance of ُ’daman al-milikiyyah as a fundamental condition for profit in Islamic financial transactions.

Keywords Risk, ownership, uncertainty, liability, responsibility, ُ’daman al-milikiyyah

Paper type Research paper

Introduction

Throughout the passage of time, economic systems have grappled with the concept of ownership and its characteristics. Regardless of the social organization in place – feudalism, socialism or capitalism – ownership is fundamental to any economic system. To understand the practical applications of an Islamic economic system, one must understand the Islamic
notion and conceptualisation of ownership. Similar to secular economic systems, an Islamic economic system places strong emphasis on the protection of private property rights. However in Islam, private property rights are not limited to private benefit but are also intended to promote and ensure social benefits. This paper argues that the source of any legitimate and profitable economic activity rests with the concept of *damān al-milkiyyah* (ownership risk). This concept will be described in detail in the second section, followed by its practical applications in the third section. The final section concludes the discussion.

**The concept of *damān al-milkiyyah***

To adequately address the concept of *damān al-milkiyyah*, this section is divided into three subsections. The first two subsections comprise separate descriptions of *al-milkiyyah* (ownership) and *damān* (liability), and this is followed by an explanation of *damān al-milkiyyah* in the third subsection.

*Al-milkiyyah*

From an Islamic perspective, mankind is the *khalīfah* (vicegerent) of this world, and the ownership of all things belongs to Allah (SWT). This is consistent with the Qur’anic verse: “To Allah belongs the dominion of the heavens and the earth and all that is therein” [5:120]. In Islam, *al-milkiyyah* (ownership) refers to the legal relationship between a human being and property that renders the property specifically attached to him. This relationship confers upon the owner the right to deal in that property in the absence of a legal impediment to a specific dealing (Al-Zuhayli, 2003b). Ownership and other legal rights can only be established through an Islamic legal recognition of that right. These rights are derived from the sources of Islamic law. Legal rights are granted to the vicegerents of property, who are entrusted to utilize property in accordance with Islamic teachings.

Classical jurists consider the protection of property rights to play a major role in an Islamic economic system. Al-Zuhayli (2003b) considers the best definition of ownership provided by jurists to be “an exclusive association of the owned item with its owner, which gives the owner the right to deal in what he owns in any way that is not legally forbidden”. Thus, the acquisition of a property in a legal manner grants the exclusive right of use and dealings to the owner as long as no legal impediment applies to his dealings, for example, insanity or childhood. This exclusivity of ownership forbids others from utilizing the property or dealing in it without legal authorization such as guardianship or agency.

A young child or an insane person is still considered to be the owner of his or her property, although he or she is forbidden from using it. Once the legal impairment to their rights is removed, their legal right to deal in that property is to be fully reinstated. The concepts of legal and beneficial ownership define how the process of guardianship and agency works. In both cases, legal ownership is held by the guardian and agent, whereas beneficial ownership remains with the original owner. Despite the incapability of a young child or insane person to manage his/her own wealth, his/her right as the owner is preserved. Al-Zuhayli (2003b) proceeds to outline in detail various issues that concern ownership including eligibility for private ownership, the types of ownership as well as the permissible means of establishing total ownership in Islam. This comprehensive treatment highlights the importance that Islam has given to ownership and to defining property rights.

Drawing on the work of the Hanbalī jurist Ibn Taymiyyah, Islahi (1996) states that each of three agents – the individual, the society and the state – has a rightful claim (ownership) on property rights. He explains that the property rights of these agents should not come into conflict with one another and the exercise of those rights by any one of the three agents should not jeopardize the exercise of rights by any of the others. Habachy (1962) argues that
any infringement on the property and the rights of another person is considered to be not only a trespass against the law but also sinful in Islam. He notes that according to Ibn Taymiyyah, “the first duty of the state is to scrupulously respect private property”. This is further supported by Imam Shafi’i, who refused to recognize the right of the sovereign to fix a fair price, even in the case of scarce necessities. He reports that Imam Shafi’i said:

People are masters of the things they own, and nobody has the right to take over these properties, totally or partially, without the consent of their owner, except in cases which are clearly specified in the law.

Therefore, it is prohibited to transgress on private property that has been legally acquired. Islam has stipulated various punishments for theft, usurpation, cheating and other injustices and ordered transgressors to compensate the owners of damaged properties. The state possesses the right to intervene, confiscate and return properties which have been illegally acquired to their rightful owners, whether those properties are mobile or immobile. Furthermore, the state is allowed to limit or eliminate legally acquired private ownership rights on the condition that equity and social benefits dictate it. This is consistent with the Qur’anic verse “O you who believe: Obey Allah, obey His Messenger (peace be upon him) and obey those charged with authority among you” [4: 59].

Islam does not prohibit private ownership and allows individuals to benefit by engaging in economic activity through buying and selling. Beyond this, however, it is also incumbent upon those with property to contribute to social welfare through the redistribution of wealth and to contribute to economic stability through contributions to the state. This is reflected in several Qur’anic verses, for example: “O you who believe, do not consume one another’s wealth wrongfully; rather, let there be trade by mutual consent” [4: 29]; also “And in their wealth and possessions are rights of the needy” [51: 19]. Therefore, there is an obligation or social responsibility embedded in private ownership which needs to be fulfilled.

**Dāman**

*Dāman* is an important concept in *fiqh* literature throughout various areas of Shari’ah (Islamic law). In the context of Islamic commercial transactions, Jaffar (1994) states that *dāman* forms one of the most complicated subject matters in the Islamic law of obligation. In the literal sense, *dāman* refers to security or bail. In the practical sense, *dāman* has various connotations including responsibility, accountability and surety. *Dāman* is sometimes synonymous with *kafūlah* (surety) but is much wider in scope. In the general expression, *dāman* is perceived as an obligation to provide indemnity and reparation or *ghurum*. In particular, *dāman* is accepted as the holding of the guarantor’s *dhimmah* (responsibility or liability) in respect of *huqūq* (rights). The term *dāman* is not used in the Qur’ān, and the occurrence of the word *kafūlah* on numerous occasions cannot be taken as sufficient proof for the legality of *dāman* in the Qur’ān. Nevertheless, the use of the term *dāman* is treated extensively in the Sunnah of the Prophet (peace be upon him), as well as other synonymous terms (Wizarah al-Awqaf wa as-Shu’uun al-Islamiyyah Kuwait, 2006) such as *kafūlah* (surety or guarantor), *za’āmah* (guarantee through political status), *qabālah* (guarantee through collateral proceeds) and *hamālah* (guarantee in blood money).

Elgari (2003) explains that the word *dāman* carries numerous meanings in the terminology of jurists. On the one hand, Shafi’i, Maliki and Hanbali jurists use the word *dāman* to mean *kafūlah* in the context of the fulfilment of one’s *dhimmah* by another. On the other hand, Hanafi jurists use the term *dāman* in the context of obligation as financial compensation for injury or damage caused to another. Nevertheless, the majority of jurists use the term to mean bearing the burden, liability or responsibility in the event of...
destruction of goods sold, and they deem this to be a condition for the validity of a sale after purchase. Additionally, for the majority of jurists, the purpose of possession is the transfer of *damān*, i.e., the liability for bearing the loss due to destruction, from the seller to the buyer. Thus, a sale with an unknown subject matter is prohibited unless it is determined, as it provides surety. This enables transfer of ownership to the buyer through offer and acceptance, with the liability resting with the seller.

Therefore, *damān* should not be defined as “risk” in the conventional sense. In conventional finance, risk is commonly referred as a situation in which two or more outcomes are possible. Hence, circumstances are said to bear no risk if only one outcome is possible. However, the term risk is often used analogously with uncertainty. This is a long-held misconception, as Knight (1921) warned:

[...]

Therefore, in conventional economics, Knightian uncertainty is defined as risk which is unmeasurable or not possible to calculate.

This Western confusion notwithstanding, the conventional concepts of risk and uncertainty, measurable or otherwise, bear closer resemblance to *gharar* than *damān* in *fiqh* terminology. Literally, *gharar* means uncertainty which signals danger and deception. Technically, *gharar* refers to something with concealed or uncertain characteristic. Although the prohibition of *gharar* is not explicit in the Qurʾān, it is well established in the Sunnah. For example, Ibn Masʿūd (may Allah be pleased with him) narrated that the Prophet (peace be upon him) said: “Do not buy fish in the water, for it is *gharar*”. Al-Zuhayli (2003a) explains that a *gharar* sale is the sale of that:

- which is not known to be in existence or otherwise;
- whose measure is not known to be large or small; or
- which is undeliverable.

Generally, the majority of jurists allow for *gharar yasīr* (minor uncertainty) and prohibit *gharar fāḥish* (excessive uncertainty). In an Islamic economic system, therefore, risk or uncertainty is to be minimized in financial transactions and should not be manipulated to become a source of profit. Profiting from excessive uncertainty is ruled as unjustified income, as it promotes injustice and does not preserve the right of the seller. Therefore, the concept of *damān* in the context of *damān al-milkiyyah* refers not to risk in the conventional sense but more accurately refers instead to the liability or responsibility arising from ownership.

*Damān al-milkiyyah*

The concept of *damān al-milkiyyah* is best understood through two legal maxims: “*al-kharāj bi al-ḍamān*” (benefit goes with liability) and “*al-ghurm bi al-ghumn*” (liability accompanies gain). These are among the most important maxims with regard to Islamic financial transactions, as they embody one of the fundamental principles governing financial transactions: justice and fairness for all contracting parties (Laldin et al., 2013).
The general meaning of the first maxim, “al-kharaj bi al-ḍamān”, is that the benefit of an asset is the right of the one who indemnifies it if it is damaged (Laldin et al., 2013). For example, a buyer who has an option or khiyār to return a purchased asset to the seller due to the non-disclosure of a defect is entitled to the benefit of that asset during the option period as compensation for his liability to indemnify it in case the asset is damaged. In another example, a debtor can enjoy the benefits of money borrowed because he is liable to return the principal under all circumstances. On the other hand, the lender who bears no liability is not entitled to any gain as qard (loan) transfers ownership to the borrower. Nevertheless, this maxim only applies to the liability that comes from lawful possession. An asset’s possession is regarded as lawful when ownership transfer takes place through trade or the owner’s permission when the possessor takes possession for his own benefit (Laldin et al., 2013). Therefore, although a thief and a usurper are both liable for any damage that occurs to the property when it is in their possession, they have no right to any yield from it, as they are transgressors. This is because no legal ownership is recognized from their illegitimate possession. Thus, it can be deduced that possession of an asset does not necessarily justify the gain received. In Sharī’ah, any gain received can only be deemed lawful when ownership comes with liability. Hence, the yield of an asset is only justified to the one who owns the asset and bears liability. The following conditions must also be fulfilled for this concept to apply:

- the benefit of the asset is separate from the principal, whether it is generated from the asset or otherwise; and
- the additional benefit comes into existence after the ‘illah (cause) of ownership was concluded.

The general meaning of the second maxim, “al-ghurm bi al-ghumn”, is that the owner of an asset has to bear all the losses and costs that attend ownership of the asset because he is entitled to enjoy any benefit resulting from it (Laldin et al., 2013). This maxim decrees that one party in a venture cannot shift all risk to another party and still maintain a legitimate right to the profits generated. Thus, legitimacy of the profit generated from any business is associated with the risk borne by the business owner. These two maxims support one another, as one can be thought to be the inverse of the other. The Sharī’ah legitimacy of profit has been extensively discussed in the literature. For example, according to the Malikh jurist Ibn al-Arabi, “Every increase devoid of an equivalent countervalue (iwasd) is rūba”. This explains the idea of trade, where an exchange of countervalue transfers the liability and ownership of both. By contrast, in ribā-based (interest-based) transactions, liability remains with the borrower, as there is no recognized countervalue. Hence, the absence of an equivalent countervalue would delegitimize any profit gained. More recently, Rosly (2001) explains that an equivalent countervalue must consist of three main elements: namely, ghurm (market risk), sa’y (effort) and ḍamān (liability). Similarly, Laldin et al. (2013) state that jurists have identified three factors that the Sharī’ah recognizes as justifying profit: mal (capital), ʿamal (labour) and ḍamān (liability). Thus, the ḍamān that arises from milkiyyah (ownership) can be considered as the cornerstone of any legitimate and profitable economic activity. An owner cannot transfer his liabilities while still retaining ownership rights if he seeks to profit from any economic activity.

The legality of the two maxims is derived from the following ḥadith. Imām Shāfiʿī, Imām Ahmad, the compilers of the four Sunan and al-Ḥākim recorded by way of ‘Urwa from ‘Ā’ishah (may Allah be pleased with her) that a man had purchased a slave during the time of the Prophet (peace be upon him), and he remained with him for some time according to the will of God. Thereafter, he returned him on the basis of a defect that he found. The Prophet
(peace be upon him) judged in favour of his return on the basis of the defect. The person against whom the decision was given said, “But he benefited from him”. The Prophet (peace be upon him) then replied: “Al-kharāj bi al-dāmān” (Elgari, 2003). The majority of jurists support this hadith, although some have disagreed about the chain of transmission as well as its legal content[1]. Some jurists such as Imām Ahmad restricted the meaning of the tradition to food, whereas others disagreed about the jurisprudence of the tradition. Elgari (2003) argues that “al-kharāj bi al-dāmān” is not a general principle nor is it inviolable. He bases this view on the hadith about musarrāh[2] and the hadith on reducing the price on account of calamities. However, these examples appear to be mere exceptions to the rule rather than general rules in themselves.

In general, these maxims illustrate the importance of dāmān al-milkiyyah and appear to be relevant to all nominate contracts of Islamic finance such as murābahah, mushākarah, muḍārabah, ijārah and others. Having described the concept of dāmān al-milkiyyah, the next section will turn to the applications of the concept in Islamic banking and finance from an Islamic law of contract perspective.

The application of dāmān al-milkiyyah

Islamic banking and finance have emerged and developed over the past four decades to become an increasingly important segment of the financial system in many parts of the world, particularly in the Middle East and Southeast Asia. The main reasons for its emergence are the widespread involvement of ribā in the conventional system and the perception that the conventional system is not set up towards achieving maqāṣid al-Sharīʿah (the objectives of Islamic law) (Siddiqi, 2006).

The literal meaning of ribā is increase. According to the majority of scholars, the technical definition of ribā refers to any contractually stipulated addition given or taken above the amount borrowed or lent. The relationship between dāmān al-milkiyyah and the prohibition of ribā is clear. When a sum of money is lent, ownership of that same sum of money is transferred to the borrower, who is entitled to benefit from its usage. However, to have that benefit, the borrower must be liable for any possible damages to the sum of money. The prohibition of ribā implies that the lender is not allowed to profit from the loan because the dāmān rests with the borrower. In other words, the borrower is liable to repay the principal in all circumstances. Because the lender no longer has ownership of the sum of money, he is not liable for any loss that occurs to it. As such, the lender is merely entitled to receive the principal sum from the borrower.

The development of Islamic banking and finance has led to the proliferation of various Islamic financial products and services to meet the needs of contemporary society. The applications in Islamic banking, Islamic capital markets and takāful will be discussed in the next two subsections in the context of dāmān al-milkiyyah.

Islamic banking

The conventional banking business model is based on the interest rate spread, which is the difference between lending and deposit rates. As interest is prohibited, Islamic banks need to operate under a different business model. This business model requires the use of Sharīʿah-compliant deposit and financing products, which are derived from various sale-based, lease-based, partnership, fee-based and benevolent contracts. Different rules and conditions govern the different types of contracts to facilitate financial transactions.
Deposit products

Generally, there are two types of deposits: savings[3] and investment deposits. While the underlying contracts used must be Sharī‘ah-compliant, they must also be aligned with the intention of the depositor to attain the muqtaḍā al-ʿaqd (fundamental effects of the contract), whether it is for saving or investment purposes.

Savings deposits should be based on the wadī‘ah (trust) or qard (loan) contract, which allows for the safe-keeping of the deposited asset. Technically, an Islamic bank is allowed to charge a fee for the safe-keeping service based on the costs incurred. Wadī‘ah can be of two types: wadī‘ah yad amānah, which refers to property deposited on the basis of trust, and wadī‘ah yad ḍamanah, which refers to savings with guarantee or safe-keeping (Qaed, 2014). In a wadī‘ah yad ḍamanah contract, the bank is not responsible for any damages except due to its own negligence or wrong-doing. This is due to the fact that such contract is trust-based. The bank bears no responsibility nor ownership of the deposit. Hence, it is not entitled to gain from the deposits made and is obliged to return the savings upon demand by the depositor. In contrast, in a wadī‘ah yad ḍamanah contract, the principal amount deposited is guaranteed by the bank, which will bear the liabilities in the event of any losses incurred. The reason of such liability is due to the trust contract made earlier which has been breached by the bank’s utilization of the money. Thus, the contract now mimics the characteristic of qard except that legal ownership remains with the depositors. Now, the bank has the right to profit from the utilization of the deposited asset (ISRA, 2016). Similarly, the use of a qard contract also provides the depositors with guaranteed safe-keeping of the amount deposited and, at the same time, allows the bank to utilize it for its banking and business activities as ownership and liability now reside with the bank.

Therefore, in the case of wadī‘ah yad amānah, the funds are deposited on the basis of trust and are not to be utilized by the bank for economic activity. However, for wadī‘ah yad ḍamanah and qard, although the funds can be utilized for economic activity by the bank, the depositor does not bear ḍaman or responsibility of the utilized funds. Hence, in line with the concept of ḍaman al-milikiyyah, the depositor is not entitled to any return from the principal sum. Nevertheless, the bank may choose to pay hibah (a customary gift) at its own discretion. However, it is not allowed for the bank to declare nor promise any form of return to its depositors. The rationale for Islamic banks to do this is to stay competitive with conventional banks, who typically pay a positive rate of interest on savings deposits[4].

Investment or term deposits are typically accepted for a fixed period of time, during which no withdrawals are allowed. The most suitable contracts for Islamic investment deposits are partnership contracts such as mushāraakah or muḍārabah. Under a mushāraakah contract, depositors share the profits and losses in a joint enterprise. Under a muḍārabah contract, the muḍārib (entrepreneur) supplies labour and the rabb al-māl (investor) supplies capital. If the venture yields a loss under muḍārabah, the entrepreneur loses his time and effort, whereas the investor loses his capital. Under both contracts, the depositors are considered to be partners and thus bear ownership and hold liability of the specified venture. Hence, the depositor is entitled to returns from the investment deposit, in line with the concept of ḍaman al-milikiyyah. In other words, the risk or liability due to each depositor from his or her contribution entitles them to a legimate share of the profits. Thus, the profit or loss due to each party is dependent on the performance of the venture. However, this may be unattractive to depositors who may be accustomed to having guaranteed returns and capital protection under conventional term deposits. Such guaranteed returns and capital protection are deemed to be impermissible according to Islamic law and run counter to the concept of ḍaman al-milikiyyah. Jurists of all schools have reached ijmā‘ (consensus) over the centuries that pre-specification of investment profits in any form of partnership is not
allowed, whether it is a certain amount or a percentage of the capital (Laldin et al., 2013). This ruling is based on the view that such a pre-specification guarantees the principal capital, which violates the essence of partnerships (silent or otherwise), which is profit-and-loss sharing. This consensus is well established amongst jurists, and no dissent has been reported.

In practice, however, investment or term deposits have often utilized a commodity murābāḥah structure. This is a deferred sale or instalment credit sale which uses a commodity as an underlying asset for the transaction. Commodities used should be non-perishable, freely available and can be uniquely identified. Typically, this structure utilizes metals from the London Metal Exchange or crude palm oil from Bursa Suq al-Sila in Malaysia. The mark-up from the deferred sale is used to provide a fixed return over the term deposit period. This structure however, is not uncontroversial. Although widely practiced in Malaysia and other countries, it is frowned upon in the majority of other jurisdictions as the genuine transfer of constructive ownership may not actually take place (Dusuki, 2010). If transfer of ownership does not take place, then the depositor never bears any liability (damān) from the commodity murābāḥah programme. Therefore, from an Islamic law of contract perspective, the depositor would only be entitled to receive the murābāḥah mark-up if he sufficiently takes on damān al-milkiyyah.

**Financing products**

The lender-borrower mindset of a conventional loan sets the ground of debt-based financing, where interest is the main source of profit. However, the only type of financial debt explicitly acknowledged in Islam is qarād hasan, which is a benevolent loan. This refers to a non-interest loan which does not have a compulsory term of repayment. Loans in Islam are a form of charity, which explains why interest is irrelevant here. On the other hand, the borrower is perpetually obliged and liable to return the amount borrowed unless waived by the lender himself. In return for the liability he holds, the borrower is entitled to the ownership of the amount borrowed and is thus rightfully entitled to any gain.

Due to the prohibition of interest, Islamic banks are required to seek other means of benefiting from financing activities. They are required to bear ownership risks such as price risk or the risk of destruction of an asset to legitimize their returns from financing activities. Although conventional banks providing ribā-based loans are exposed to risks related to default and delinquency, such risk exposure is not sufficient for Islamic banks (Obaidullah, 2005). It is here that the distinction between risk and liability is helpful in clarifying the concept of damān al-milkiyyah. For a loan, it is the debtor who is the bearer of damān and can, therefore, benefit from using the money. Because the creditor or Islamic bank is free from damān, then stipulating higher repayment above the principal amount is not merited.

Various financing products have been introduced to facilitate the development of Islamic banking and meet the needs of contemporary societies. The more popular financing products resemble debt with predetermined payments and are structured on sale-based contracts such as murābāḥah (cost-plus sale) and bay′ bi-thaman ajil (BBA or deferred payment sale) and lease-based contracts such as ijārah (leasing). Less popular financing products include other types of sale-based contracts such as salam (deferred delivery sale), istīṣāʿ (manufacture sale), istijrār (recurring sale), as well as equity-based financing products such as muḍārabah (trustee partnership), mushārakah (joint venture) and mushārarakah mutaniqāsah (diminishing partnership). Furthermore, Islamic banks also provide fee-based commercial banking products and services such as wakālah (letter of
credit) and kafālah (letter of guarantee) (Obaidullah, 2005). In certain jurisdictions, the use of controversial debt-based products such as bayʿ al-ʿinah (repurchase), bayʿ al-dayn (bill discounting), tawarruq (tripartite resale) are deemed to be acceptable and have become the predominant form of financing. These debt-based products are controversial as the creditor does not appear to bear any liability that would legitimize their profit in line with the concept of ḍaman al-milikiyyah. As such, these products may only be Sharīʿah compliant in form but not in the spirit of maqāṣid al-Sharīʿah.

In determining whether a particular product is Sharīʿah compliant or not, Sharīʿah scholars typically address whether the ‘aqd (contract) fulfills validity requirements, namely, contracting parties (buyer and seller), price, subject matter and offer and acceptance. However, Rosly (2008) argues that it is insufficient to determine the Sharīʿah legality of a financial transaction from purely an ‘aqd perspective. Rather, he argues that Sharīʿah scholars should also address its legality from a more holistic approach which incorporates maqāṣid al-Sharīʿah, financial reporting and legal documentation. These additional approaches enable Sharīʿah scholars to establish the substance as well as the form of the contract. Rosly (2008) provides the example of a financing facility based on a murābāḥah or BBA contract which may fulfill the validity requirements from an ‘aqd approach. However, he argues that the financial reporting approach would be able to show whether the bank held ownership prior to the murābāḥah sale. Prior to the murābāḥah sale, the subject matter of trade should be recorded as a fixed asset in the bank’s balance sheet. Once the murābāḥah sale is executed, the bank holds murābāḥah receivables. Furthermore, the legal documentation approach should highlight whether there has been a genuine transfer of ownership from the vendor to the bank and from the bank to the customer through the proper registration of ownership. Therefore, in addition to an assessment from an ‘aqd perspective, careful analysis of financial reports and legal documentation would indicate whether the bank can legitimately profit from the transaction, in line with the concept of ḍaman al-milikiyyah.

In the context of maqāṣid al-Sharīʿah, basic principles of justice must be upheld. Consumer protection is imperative, and this should be reflected in the design of financial contracts. In Islam, khiyār al-ʿayb (option of defect), khiyār al-ruʿyah (option of inspection) and khiyār al-majlīs (option during the contract session) should be acknowledged as the natural rights of the buyer or consumer. Furthermore, various other options can be negotiated between the two counterparties such as khiyār al-shart (stipulated option). Similarly, the bank should also receive legal protection from the court in the case of mumātalah (wilful customer default). This does not necessarily imply full recourse to the unfulfilled obligation but rather should be commensurate with actual costs and liabilities borne by the creditor. These principles highlight the importance of risk minimization and the clear assignment of property rights in Islamic financial transactions. Therefore, due to the existence of various khiyār, whether implicit or explicit, neither party should be allowed to profit if no actual ownership risk is borne.

In practice, however, Islamic banks and other financial institutions appear to minimize ḍaman al-milikiyyah. For example, the time period between two sales in a murābāḥah financing is restricted to “minutes, if not seconds” (Hegazy, 2007). This means that the current form of murābāḥah is far removed from its original form as a sale of trust. Here, the potential buyer does not rely on the professional judgment or expertise of the seller. Furthermore, the buyer does not need to rely on the trustworthiness of the seller because he has full knowledge of the different components of the mark-up price, including the original price, shipping costs and the mark-up margin. In banking murābāḥah, it is sometimes the buyer rather than the Islamic bank that spends the time and effort identifying and locating
the desired goods and even negotiating the price with the original seller[5]. It is common practice for an Islamic bank to appoint the murābahah customer as the agent (wakīl) to negotiate and purchase the goods from the supplier of such goods on behalf of the bank. Thus it is unclear whether the mark-up charged is commensurate with the ḍamān held by the bank.

As another practical example, lessors in an ījarah contract may seek to avoid ownership risks by stipulating that the lessee bear all the costs pertaining to the lease. The subject matter of an ījarah contract is the usufruct of the leased asset, which is gradually collected over time. Hence, when the leased asset develops a defect, it would occur prior to receipt of the usufruct. This gives the lessee as buyer of the usufruct an option in analogy to the sale contract. Therefore, if a defect that adversely affects the usufruct of the leased object develops, the lessee has an option to maintain the lease and continue to pay the full rent or to void the contract. As the corpus of the leased property remains in the ownership of the lessor, all the liabilities that emerge from the ownership of the lessor should be borne by the lessor, whereas the liabilities which relate to the use of the property shall be borne by the lessee (Usmani, 2006). This means that in an ījarah-based mortgage where house ownership belongs with the lessor/owner throughout the entire ījarah period, the lessor bears the ḍamān of the property and should be liable for taxes as well as major repairs that would impair use of the house not caused by the tenant’s negligence, wrong-doing or misuse. On the other hand, the tenant bears the ḍamān of the usufruct and hence should be liable for utility bills and other such expenses.

Finally, certain parties may also restrict their exposure to ḍamān al-milikiyyah in practical applications of partnership-based contracts through the use of guarantees. To protect against breach of trust (tuʿaddī) by the customer, Islamic law permits a bank under a profit-and-loss sharing structure such as muḍarabah or mushārakah to obtain a guarantee or asset pledge as security. However, it is not permissible for the bank to demand security against the potential loss of original capital or failure to achieve a minimum level of return due to an external reason not attributable to the client. Any form of capital guarantee would go against the concept of ḍamān al-milikiyyah. For instance, an Islamic bank and a client can jointly form a partnership based on mushārakah mutanāqiṣah, wherein house ownership is explicitly shared in proportion to their capital contributions. Under such a contract, the bank rents out its ownership portion of the property to the client and receives periodic payment which is divided into two parts: one part paying a proportionate rental payment based on the bank’s share of the property, and the other part is an equity contribution by the client to gradually purchase the bank’s share of the property. In line with the concept of ḍamān al-milikiyyah, the bank should not impose on the customer an undertaking to purchase the bank’s share in the event of default. However, it is permissible for the customer to undertake to sell its share to the bank at market price in the event of default (Naim, 2011).

Islamic capital market
The Islamic capital market refers to the market in securities such as equities, bonds and derivatives that satisfy Sharīʿah compliance. For equity instruments, compliance is relatively straightforward as the Sharīʿah explicitly prohibits investment in harmful business activities such as alcohol, tobacco and other prohibited items. However, there is a degree of variation between different Sharīʿah screening methods that have been used. A particularly contentious issue has been the threshold of debt represented in a share that would prevent the share from being tradeable (see for example, Khatkhatay and Nisar (2007) and Obaidullah (2009)). Instruments in the bonds and derivatives market are more...
complex and need to be completely redesigned to achieve Shari‘ah compliance. This is because the Shari‘ah condones partnership and profit-and-loss based financing but prohibits interest-based debt financing (Bacha and Mirakhor, 2013). This section will discuss the application of ḍamān al-milkiyyah with regards to Islamic alternatives to instruments in the bonds and derivatives markets, in particular, sukūk as well as Islamic derivatives.

Sukūk

Sukūk is commonly referred to as an Islamic bond, though this representation is misleading. Bonds are instruments in which an investor loans money to an entity, corporate or governmental body, which borrows the funds for a defined period of time at a variable or fixed interest rate. Bonds, such as sukūk, are used to raise external financing. However, unlike bonds, sukūk represent ownership shares in assets that bring profits or revenues, such as leased assets, or commercial or industrial enterprises or investment vehicles which may include a number of projects. Returns to sukūk should be directly linked to the performance of the underlying asset, whereas bond yields are detached from real economic activities.

For example, in the case of mushāarakah sukūk, the issuance of sukūk represents an undivided ownership of capital raised after the closure of subscription. Once the venture has commenced and the raised capital has been injected, the sukūk programme becomes binding and thereafter the sukūk can be traded in the secondary market at market value. If the sukūk programme is rescinded, the sukūk holders are entitled to redeem their capital at par value rather than market value as the sukūk have not been listed and traded (Soualhi, 2015). Profits and losses are shared in proportion to the capital provided, in line with the concept of ḍamān al-milkiyyah.

In practice, however, many sukūk have been structured in a way which creates doubt regarding their representation of ownership. At the end of 2007, Sheikh Taqi Usmani famously stated that 85 per cent of all existing sukūk were not Shari‘ah compliant. This is due to several reasons which all contravene the concept of ḍamān al-milkiyyah. Firstly, some sukūk use shares of companies as the underlying asset but do not confer true ownership. Instead, they merely offer the sukūk holders a right to returns, which is not lawful from a Shari‘ah perspective. Secondly, many sukūk undertaken by Islamic banks or institutions consist of a mixture of ijārah, istisnā‘ and murābahah contracts that are packaged and sold to sukūk holders. The inclusion of the murābahah element brings into question the issue of sale of debt. Thirdly, for many sukūk the distribution of profits is linked to fixed percentages based on interest rates such as LIBOR. Fourthly, many sukūk guarantee the return of principal to the sukūk holders at maturity. This is done through the (mis)use of binding promise (wa‘d) from either the issuer or the manager to repurchase the assets represented by the sukūk at a predetermined price, regardless of their true market value at maturity (Usmani, 2008).

Nevertheless, despite the question raised about it, several countries allow the sale of debt, provided it meets certain conditions and is sold at par. Furthermore, the absence of full ownership transfer is justified by differentiating between legal and beneficial ownership. Legal ownership gives control and power of decision to the holder, whereas beneficial ownership entitles the holder to gain and loss. This can be clearly analogized and reflected through the concept of guardianship and agency. The linkage of the fixed percentage to an interest rate remains a recurring feature, as having an Islamic pricing benchmark is still a work in progress.
Islamic derivatives

Derivative instruments are financial instruments that derive their value from the value of an underlying asset. It is a claim on the underlying asset at a predetermined price and predetermined future period(s). The most common types of derivatives are forwards, futures, options and swaps (Bacha and Mirakhor, 2013). Classical jurists of all schools of jurisprudence forbade conventional forward contracts, where both the price payment and delivery of sale object are stipulated as future liabilities (El-Gamal, 2006). However, Kamali (2002) disputes the Sharīʿah reasoning behind the prohibition of futures and options. He argued that such financial derivatives enable countries and traders to protect themselves against adverse price movements in goods and currencies in the international market. In the absence of viable alternatives, the use of derivatives is seen to be a necessity for Muslim countries and traders to compete internationally. He further argued that financial derivatives under the correct legal and regulatory framework can help to eliminate excessive forms of gharar.

While this is the position taken in Malaysia, other jurisdictions have been less amenable to the idea. Instead, they side with the Islamic Fiqh Academy, which resolved that all forms of conventional options traded as independent contracts are impermissible. Derivatives can be characterized as a zero-sum game in which a gain for one party is reflected by an equivalent loss to the counterparty. From an Islamic point of view, risk cannot be traded independently from ownership of the underlying asset, as it is against the concept of damān al-milkiyyah. On the other hand, conventional derivatives sever risk from ownership, treating risk itself as a commodity (Al-Suwailem, 2006). The application of derivatives is thus a contentious issue for Islamic finance. Although derivatives are primarily designed for hedging purposes, they are commonly manipulated for speculative purposes. The legal and regulatory framework that governs such financial derivatives should ensure derivatives are used for genuine hedging purposes and should minimize their use for speculative risk-taking purposes.

In an exploratory study of Arab-Muslim classical literature, Belabes (2017) shows that the notion of risk precedes modern times and is not absolutely forbidden. He argues that risk-taking in the productive economy is generally encouraged as everyone stands to benefit. However, he adds that risk-taking should be avoided if it leads to a game in which one’s gain is obtained at another’s expense. In the context of derivative instruments, the Sharīʿah does provide for the introduction of options as conditions in the framework of khibār al-sharīʿ (Obaidullah, 1998, 1999). Khibār al-sharīʿ is to be mutually agreed by all counterparties and is approved as an exceptional case to allow for risk management or mitigation rather than for profit or speculation. Furthermore, Al-Suwailem (2006) also outlines several Islamic hedging instruments which integrate risk with ownership and are thus value-added activities. Several Islamic modes of finance, including muḍārabah, mushārakah, murābahah and salam, can be used to cover a wide range of risks including capital risk, liquidity risk, rate of return risk as well as currency risk. This would ensure the possibility of mutual gain while reducing and managing risk. Additionally, he explains that hedging could also be carried out through cooperative or not-for-profit arrangements. The implementation of such derivative instruments in contemporary Islamic finance would be more widely accepted, as these alternative arrangements do not conflict with damān al-milkiyyah.

Takāful

In conventional insurance, the insured party transfers risk to the insurer in exchange for a predetermined payment or premium. Takāful, as a Sharīʿah-compliant
alternative to conventional insurance, is based on the principles of *tabarruʿ* (donation) and *taʿawun* (mutual cooperation). Risk, and hence reward, is to be shared jointly among participants rather than transferred to a particular party. *Takāful* is generally defined as a mutual guarantee provided by a group of people living in the same society against a defined risk or catastrophe befalling one’s life, property or form of valuable things (Billah, 2007).

The participants of a *takāful* scheme (policyholders) agree to periodically contribute an amount based on the type of policy they want to avail. Typically, the contributions go into a joint pool that is held in trust and managed by a *takāful* operator who is entitled to receive *wakala* (agency) fees. For example, in the context of family *takāful*, Mohd Noor and Abdullah (2009) explain that the death of a participant obliges the *takāful* operator to pay a sum to the participants’ nominee from the *tabarruʿ* fund. The matter of to whom they are paid is left to the agreement or the stipulation made by the policyholder to the company. However, Habib and Shaukat (2016) argue that the initial donation made would only be valid if participants cease to have ownership over the *takāful* fund. Hence, the donations should be made without any condition of compensation. This implies that existing *takāful* models are arguably structured on the basis of a conditional gift. As such, the contributions made will become an exchange contract which is subject to the same harms as conventional insurance. *Takāful* should therefore not be structured as a for-profit enterprise. It is only when the contributions of the participants represent genuine, unconditional donations that the non-commutative nature of payments immunize the *takāful* model from *gharar*, *ribā* and *maysir*.

As the *takāful* fund is held in trust, it is owned neither by the participants nor the *takāful* operator. Thus, neither the participants nor the *takāful* operator is entitled to financially profit from the operation. Hence, the concept of *ḍamān al-milkiyyah* does not apply in the context of *takāful*. Although participants customarily benefit from the *takāful* fund at the discretion of the fund’s management, it is important to remember that the intention of *takāful* is not in itself commercial; rather, its original purpose is for mutual protection and risk sharing.

**Conclusion**

According to the Islamic faith, the absolute ownership of all things belongs to Allah, and mankind is entrusted to act upon property in accordance to what has been ordained. Clearly defined property rights are fundamental to Islam, as the protection of property is one of the objectives of the Shariʿah. However, Islam also requires the circulation of wealth in an economy to promote and ensure social benefits. This paper unpacks the conceptual meaning of the term *ḍamān al-milkiyyah* and discusses its relevance in the context of contemporary applications in Islamic banking and finance. The central argument of this paper is that *ḍamān al-milkiyyah* is a fundamental condition which legitimizes profit in commercial transactions.

Future research could build on our descriptive research by analysing product documents used by Islamic banks to assess the application of *ḍamān al-milkiyyah* in Islamic finance practice in a deeper sense. Nevertheless, the main contribution of this paper is to elucidate the concept and general application of *ḍamān al-milkiyyah* from an Islamic law of contract perspective. It is argued that the concept of *ḍamān al-milkiyyah* does not narrowly refer to the ownership risks or uncertainties but instead refers to liabilities and responsibilities that come with ownership. Although uncertainties are normal in everyday life, risks with regard to ownership should be mitigated as far as possible. However, when it comes to commercial transactions, the liability of potential
loss cannot be separated from the ownership of real goods and services. Without bearing the liability of potential loss, any profit gained from commercial transactions would not be considered legitimate in Islam. The concept of ḍamān al-milikiyyah is to be best understood through the established legal maxims of “al-kharaj bi al-ḍamān” and “al-ghurm bi al-ghurm”, in which benefit cannot be divorced from liability.

These established principles are to be adhered to throughout all practical applications of Islamic finance. However, this essay has described several instances in Islamic banking, Islamic capital markets and takaful where profits are sought without adequate exposure to ḍamān al-milikiyyah. Such cases have not been uncontroversial, as the products have been structured to be Shari’ah compliant in form but not in spirit. Existing and suggested reforms to move Islamic finance to its truer form reflect the idea that one party can only profit if he sufficiently bears ḍamān al-milikiyyah.

A proper understanding of the concept of ḍamān al-milikiyyah is imperative for the further development of Islamic finance. It protects the right of ownership and reflects genuine liability in case of default. Effectively, it protects both parties in the immediate transaction and on a larger scale produces harmony and well being of the society, as justice is about giving rights to their rightful owners. Hence, this paper is expected to have practical relevance for regulators, financiers as well as the general public. Because the burden of liability for potential losses is an important condition for Islamic commercial transactions, this paper provides support for the promotion of greater risk-sharing contracts in Islamic commercial transactions, in the sense of sharing the burden of liability for potential losses. This reflects the idea that the role of finance in Islam is to promote and ensure social benefits. The careful reflection of ḍamān al-milikiyyah in Islamic finance contracts will protect the rights of owners and justify earnings. This would ultimately benefit the wider public in line with the objectives of the Shari’ah.

Notes
1. Al-Bukhārī, however, considered it to be a weak hadith (Al-Zuhayli, 2003a).
2. Musarrāḥ is a milk animal whose udder is tied for a few days before selling it so that milk will collect in it. This was a deceptive practice to make a goat or camel seem to produce more milk than it really did. A hadith related by al-Bukhārī and Muslim says, “Do not tie the udder of camels and goats. He who buys such an animal has an option after he has milked it. If he likes, he can keep it. If he dislikes it, he can return it along with a sāʿ (measure) of dates”.
3. Current and savings accounts.
4. Prior to the imposition of the Islamic Financial Services Act 2013 in Malaysia, some savings deposit products were based on muḍārabah. Under a muḍārabah arrangement, the capital provider (depositors) would bear all financial losses, which is incongruent with the original intention of a savings deposit.
5. Sometimes the structure is reversed, depending on the product.

References


Wizarah al-Awqaf wa as-Shu’uun al-Islamiyyah Kuwait (2006), Al-Mausu’ah Al-Fiqhiyyah Al-Kuwaitiyyah, 2nd ed., Dar al-Salasil; Dar al-Safwah; and Wizarah al-Awqaf wa as-Shu’uun al-Islamiyyah, Kuwait.

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Abstract

Purpose – This study on corporate demand for general takāful (Islamic insurance) aims to identify potential growth areas and areas for improvement in takāful business practices in Malaysia.

Design/methodology/approach – A survey on corporates’ protection needs, takāful/insurance coverage obtained and awareness on takāful/insurance was conducted for this paper.

Findings – The findings from the survey are as follows: There is potential for takāful operators to further penetrate the corporate sector, as the majority of respondents indicated willingness to spend on takāful insurance. Emphasis on takāful value propositions apart from its Sharīʿah compliance status is needed to attract corporates, as respondents were found to be indifferent on Sharīʿah compliance status of their protection. Strong market presence, expanded product offerings and efficient services were key determinants to attract takāful subscription. Respondents’ heavy reliance on intermediaries warrants strong collaboration with intermediaries to widen market outreach. The small and medium enterprises segment appeared promising, as it is found to be underserved despite having higher propensity to obtain takāful/insurance coverage compared to the overall respondents.

Research limitations/implications – This study is limited to Malaysia’s experience. The findings are indicative (though they may not be conclusive) of the target segment as well as the takāful industry as a whole.

Originality/value – The insights on respondents’ considerations when obtaining takāful/insurance coverage and the correlation of these factors with respondents’ characteristics can assist takāful/insurance providers in structuring products and business strategies to better serve this market segment. The paper may also aid discussions among researchers and regulators on areas for further development of the industry.

Keywords Insurance, corporate, business entities, general takāful

Paper type Research paper

Introduction

Malaysia is globally recognized as the leading key market in the takāful (Islamic insurance) sector, given its comprehensive and robust legal and regulatory framework, as well as the
presence of many players in the market. Among the Association of Southeast Asian Nations (ASEAN) countries, Malaysia leads the pack and holds nearly three-quarters share (76 per cent, equivalent to approximately US$3bn, based on total gross contributions) of ASEAN takāful business (Malaysian Takaful Association and EY, 2015). Since its inception over 30 years ago, there has been a growing number of players in the market, licensed by Bank Negara Malaysia (BNM) to conduct takāful or re-takāful business, with eight composite takāful operators, three family takāful operators and four re-takāful operators currently in the market. The Malaysian takāful sector has also witnessed a steady growth in size of contributions, with 9.2 per cent average annual growth for 2011-2015.

The family takāful sector in Malaysia is noted to make up the larger portion of the takāful operators’ business portfolio, as measured by the size of contributions. As at the end of the third quarter of 2016, net contributions for family takāful business grew by 8.7 per cent on a year-on-year basis and accounted for 75.5 per cent of market share of takāful business in the country. Malaysia is also recognized as the largest family takāful market in the world, with total contributions of around RM 4.8bn registered in 2014.

On the other hand, the growth trend of the general takāful business for the past five years has moderated to 11.4 per cent average annual growth for 2011-2015, as compared to the growth rate of 17.3 per cent in the years 2007-2010. Arguably, many factors could have contributed to this scenario. From the supply perspective, the limited business appetite of takāful operators for general takāful business—which is focused more on motor- and fire-related products—is one of the reasons for the moderate growth in the general takāful market. Other possible reasons that could be inferred for such inclination include the limited capacity of takāful operators to withstand the nature of the general takāful business, which can be more capital-intensive. It also involves a wide range of risk exposures that require specific expertise and appropriate business scale for the business to be viable.

Notwithstanding that, the landscape for the takāful industry is also expected to be more challenging in the coming years, with multiple developments and structural changes affecting the market environment. The implementation of the Islamic Financial Services Act 2013 (IFSA) requirement on conversion of composite business to single takāful business is one of the major factors that will change the dynamics of the takāful industry. Compounded by the effect of phased liberalisation of motor and fire tariffs, which commenced on 1 July 2016, the general takāful sector, in particular, is expected to undergo a shift in business dynamics and marketing strategy. It is crucial for takāful operators to develop appropriate business strategies to adapt to the new market setting and rise to any impending challenges to remain relevant and competitive.

Premised on the circumstances described above, this study is conducted to gain further insights on the potential areas of growth and improvement for general takāful. Particular focus is given to the prospect of demand and areas of opportunities that can be unlocked to better position takāful business in the market. This study particularly aims to:

- gauge the level of awareness of target respondents on the availability of takāful and insurance coverage to address their protection needs;
- understand target respondents’ takāful or insurance needs and how these needs are met;
- identify factors considered by target respondents in securing takāful or insurance coverage; and
- understand target respondents’ experience in securing takāful or insurance coverage from takāful operators or insurers.
This paper comprises four main sections. After the introduction, it outlines the methodology adopted for the study. The findings gathered from the study are outlined and discussed in the next section. The final section captures the summary of the findings and provides recommendations.

**Survey methodology**

*Survey design*

A survey questionnaire was prepared for conducting the study. The survey questionnaire used close-ended questions with predetermined options of answers for respondents to choose from. For the answer options, a mix of “Likert-type scales”, “Yes-No options” as well as “Multiple choices” were used.

The survey questionnaire was prepared in English and Bahasa Malaysia for circulation. The questionnaire set contained three main parts, namely, Part A: protection needs and awareness; Part B: insurance or *takāful* coverage take-up; and Part C: profile of organization (i.e. the respondents). Additional Part D was set to provide options for the respondents to permit further contact with them. The survey comprised a total of 20 questions.

*Distribution of survey*

Distribution of the survey questionnaire was done via two main channels: an online platform (including electronic mail) as well as hard-copy distribution.

The team collaborated with SME Corporation Malaysia, the Federation of Public Listed Companies Berhad and Malaysian Takaful Association for the distribution of the survey.

*Target respondents*

The survey focused on corporations and organizations in Malaysia (non-business as well as business entities) as the target respondents. General *takāful* protection can be the solution to the various types of risks inherent to the day-to-day operations of the target respondents; for example, business interruptions, third-party liability and property and equipment failure.

*Analyses of the survey responses*

The responses were analyzed using the descriptive method and, where relevant, the correlation technique to generate findings. This involved defining variables of investigation and analysing the interactions between the variables for the purpose of establishing characteristics of respondents, explaining their frequency distribution and measuring trends in the data gathered.

**Findings and discussion**

*Respondent profile*

A total of 246 responses were gathered from corporations and organizations of various institutional types, namely, public and private companies, government-linked companies (GLCs), sole proprietorships, partnerships, government ministries/ agencies as well as non-governmental organizations (NGOs)/non-profit organizations (NPOs).

The majority of the respondents were public or private companies as well as sole proprietors (87 per cent). A small group of the respondents were partnerships (5 per cent) and GLCs (5 per cent), with the remaining 2 per cent consisting of government ministries/agencies and NGOs/NPOs.
In terms of the length of operation and total number of employees, it was found that the majority of respondents have been in operation for more than six years and have an employee size of 31 or more staff.

It was also gathered that the top three primary businesses of respondents were related to manufacturing, property/real estate/construction and wholesale/retail sales. Figures 1, 2, 3 and 4 provide the following information, respectively:

- breakdowns of respondents according to institutional types;
- composition of respondents based on number of years in operations;
- composition of respondents based on number of employees;
Key areas of survey findings

The survey questionnaire was designed to understand the dynamics motivating demand for general takāful protection by the targeted market segment. Findings from the survey were analyzed and reported according to the following key areas:

- awareness on availability of takāful or insurance by the corporations and organizations;
- protection needs for operations of the corporations and organizations;
- factors of consideration by the corporations and organizations when securing takāful or insurance coverage; and
- the experience of the corporations and organizations in securing takāful or insurance protection.

The report on the findings includes discussion on relevant areas of assessment based on insights gathered from the survey and the information available in the current market environment.

Awareness on availability of takāful or insurance coverage

The basic area of assessment in analyzing the nature of demand for general takāful is the target respondents’ level of knowledge on takāful and insurance protection. On this note, questions were structured to gauge the target respondents’ familiarity with protection solutions (i.e. insurance and takāful coverage) that can safeguard their business from risks of financial losses arising from casualties or damages to business properties and operations.

Generally, a good level of awareness on the availability of takāful and insurance coverage was noted among the respondents. This is evident as at least 80 per cent of the respondents indicated that they were aware of the availability of takāful or insurance to protect their organizations against financial losses upon the occurrence of misfortunes. For insurance

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Figure 4.
Ranking of primary business and corresponding number of respondents
specifically, 89 per cent of the respondents affirmed their awareness about the availability of insurance coverage to cater for their business protection needs.

Comparatively, the level of awareness about *takaful* was slightly lower, i.e. 80 per cent of the respondents, as shown in Figure 5. The level of knowledge on *takaful* is found to be an area for further improvement, as, despite being aware of *takaful*, almost half of these respondents admitted that they did not know further details about it. Only around 31 per cent of the respondents appeared to have a good understanding of *takaful* vis-à-vis insurance.

Examination of the institutional structure of the respondents revealed that corporations and organizations that have larger number of employees and have been in operation longer have a higher level of awareness about *takaful*. Corporations and organizations that are linked to government (i.e. government ministry/agency, GLCs) were also noted to be more aware of *takaful* than sole proprietorships and partnerships (the latter two had the two lowest awareness levels of 17 and 15 per cent, respectively). This may be because of the involvement of *takaful* operators with many initiatives led by or associated with government ministries/agencies.

Examples of the initiatives include the provision of *takaful* coverage for BR1M recipients, fishermen under Lembaga Kemajuan Ikan Malaysia and members of Koperasi Polis Diraja Malaysia Berhad. Figures 6-8 depict these findings, based on number of employees, number of years in operation and institutional types, respectively.

These findings suggest the real need to address the current lower state of awareness about *takaful* relative to insurance. Impactful initiatives, either on the industry’s part or by individual institutions, need to be intensified towards improving consumers’ perception and understanding of the need for and importance of *takaful*. The value propositions of the *takaful* business should also be highlighted (e.g. the sharing of *takaful* surplus to eligible consumers upon the *takaful* contract’s expiry) as part of the process of educating the public and the corporate sector on the distinct features of *takaful*. Such effort is necessary to stimulate more appreciation and demand for *takaful* products.

The survey was also structured to ascertain the respondents’ propensity to subscribe to *takaful* or purchase insurance. Without looking into the preference for either *takaful* or insurance coverage, 71 per cent of the respondents indicated willingness to obtain some form of coverage to protect their corporations and organizations against risks that they considered significant to their institutions and their operations. Included in this group were the respondents (37 per cent) who already had existing *takaful* or insurance coverage and the respondents (34 per cent) who were willing to consider future subscription. Figure 9
reflects these findings. The observation on the willingness of the respondents to obtain *takāful* or insurance coverage is definitely indicative of good business prospects for the *takāful* and insurance sectors.

**Protection needs for operations of the corporations and organizations**

It is ideal that the demand for specific types of *takāful* or insurance protection be driven by customers’ protection needs. For this purpose, the respondents were asked to rate the degree of significance of the incidents and risks exposure as listed in the questionnaire to their institutions and operations (e.g. business activities, business premise, staff welfare).
Measured by frequency distribution of the subgroup respondents vis-à-vis the overall respondents for each incident and risk exposure, “physical damage to business properties” topped the list of significant incidents that can affect the respondents. “Monetary loss caused by business interruption” and “default on payment by clients” scored the second and third highest composition at 86 and 75 per cent, respectively. Relevant products in the market that provide protection against these risk exposures include fire, machinery breakdown, consequential loss and trade credit. Figure 10 reflects these findings.

The above findings correspond with the profiles of the respondents in that the top three primary businesses were manufacturing, property/real estate/construction and wholesale/retail business. These lines of business are known to deal heavily with inventory management. Their motivation to minimize the risk of monetary loss provides a strong basis for subscribing to takāful or insurance coverage. On this note, Yamori (1999) highlighted that the probability of damage varies according to industry. Some industries
definitely face higher risks than others. For example, the presence of various highly inflammable materials causes higher risk for entities operating in the chemical industry. This suggests that firms operating in a high-risk industry would have higher demand for insurance. In this respect, the business opportunity for takaful operators is not limited to the provision of takaful protection custom-made to suit potential clients’ business needs. Takaful operators could also provide consultation services related to risk management for the targeted clients.

In investigating the extent to which the above protection needs actually ended up with participation in a takaful plan or purchase of insurance, the respondents were asked to indicate which of the risk exposures as listed in the questionnaire they have takaful or insurance coverage for. The questionnaire provides for separate identification of takaful and insurance coverage for the respondents to choose from.

Based on the results of the survey, there is a relatively high subscription for takaful coverage against employee-liability-related risk exposure (22 per cent of respondents), employees’ medical-related exposure (15 per cent of respondents) and possible damages to properties because of burglary/theft (15 per cent of respondents). As the list of risk exposures roughly correspond to specific product types, the survey findings suggest that products such as “workmen’s compensation/employer’s liability” and “medical-related” are mostly subscribed for takaful. Subscription to takaful is also comparatively high for coverage related to “fire” products (19 per cent of respondents). This finding is consistent with the current position of the fire portfolio, which has the second highest share of general takaful business (20 per cent of total general takaful business) among other product lines.

When the results of respondents’ subscription to takaful were compared with that of insurance, higher subscription to insurance products was noted across all risk exposures, as illustrated in Figure 11. This is consistent with the awareness level for insurance, which is higher among the respondents.

Further investigation was carried out to ascertain the possible relationship between the respondents’ actual take-up of takaful or insurance coverage with their institutional characteristics. Two proxies were chosen, namely, the size of the corporations and organizations (measured by number of employees) and the number of years these institutions have been in operation. Based on the findings, a probability plot is produced for
Damages to business properties & premises due to fire, lighting, explosion etc [a]
Loss of/damages to business properties & premises due to burglary/theft [b]
Damages to machineries/equipment due mechanical breakdown [c]
Protection from legal liability upon employees injury/disease during employment [d]
Protection from legal liability upon 3rd party injury or damage to 3rd party’s property [e]
Loss of money/properties due to employees’ fraud [f]
Loss of money/properties whilst in transit or being kept in business premises [g]
Compensation for employees’ costs of general medical treatment, hospitalisation [h]
Others [i]

5% 19% 78%
10% 15% 73%
23% 10% 55%
4% 22% 75%
14% 15% 71%
32% 11% 53%
25% 12% 62%
11% 15% 73%
16% 8% 15%

Note: Composition of respondents do not add up to 100 per cent – a respondent could choose either only takāful/insurance/none or choose takāful and insurance

Corporate demand for general takāful

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In terms of the respondents’ age (or number of years of operations), the likelihood to purchase takāful or insurance coverage is higher for the respondents that have been in operations longer. This may be because of the sentiment that insurance or takāful coverage is not a necessity during the initial years of an institution’s establishment vis-à-vis other areas which require higher priority such as securing more businesses/clients through aggressive marketing and promotion.
Factors of consideration when obtaining takaful or insurance

One of the key areas of assessment in the survey of demand for general takaful is the respondents’ factors of consideration when deciding whether to secure takaful or insurance coverage. Given a list of factors to consider, respondents were asked to rate the degree of importance of these factors in influencing their decision on obtaining takaful or insurance. The top three factors that influence respondents’ decisions were found to be “scope of protection of the insurance or takaful” (97 per cent of the respondents), “affordability of premiums/contributions” (95 per cent) and “the quality of service offered to them” (90 per cent). These results were found by computing the frequency distribution of the subgroup respondents who ranked the factors as moderately or very important vis-à-vis the overall respondents who answered the question.

Based on Figure 14, it is interesting to note that respondents were generally indifferent whether or not their protection was Sharīʿah compliant (62 per cent of the respondents who answered this question ranked this factor as moderately or very important). On this note, a further test was carried out to see the relationship between respondents’ actual take-up of
takāful or insurance coverage and their ranking of importance for the “Sharīʿah-compliant status of the protection”. The results seem to suggest that the respondents who ranked “Sharīʿah-compliant status” as important have higher tendency to take up takāful rather than insurance coverage, compared to the overall respondents. This is evident from the results as shown in Table III.

This observation is expected, given the emphasis on Sharīʿah compliance by this subgroup of respondents. However, it is interesting to note that, despite their expressed prioritisation of compliance with Sharīʿah, most of the coverage obtained by the respondents in this subgroup was insurance coverage. There are several possible explanations for these findings. It may be that takāful operators offer less competitive products or the takāful coverage may be more limited than insurance coverage because of the limited risk appetite of takāful operators or takāful operators may have less technical expertise regarding such coverage.

In addition to the above, it is also fascinating to find that almost 60 per cent of respondents who rated “Sharīʿah-compliant status” as important were either not aware of takāful availability or did not know further details of takāful. While this posits potential for

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**Table II.**

<table>
<thead>
<tr>
<th>Legends</th>
<th>Age</th>
<th>Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>0.455775</td>
<td>0.522082</td>
</tr>
<tr>
<td>b</td>
<td>0.409374</td>
<td>0.490170</td>
</tr>
<tr>
<td>c</td>
<td>0.347472</td>
<td>0.384770</td>
</tr>
<tr>
<td>d</td>
<td>0.386048</td>
<td>0.472594</td>
</tr>
<tr>
<td>e</td>
<td>0.421341</td>
<td>0.471162</td>
</tr>
<tr>
<td>f</td>
<td>0.341049</td>
<td>0.463285</td>
</tr>
<tr>
<td>g</td>
<td>0.380486</td>
<td>0.492907</td>
</tr>
<tr>
<td>h</td>
<td>0.391621</td>
<td>0.476398</td>
</tr>
<tr>
<td>i</td>
<td>0.128633</td>
<td>0.210301</td>
</tr>
</tbody>
</table>

**Correlation test between respondents’ actual take-up of takāful or insurance coverage and respondents’ size and age**

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**Figure 13.**

Probability plot of respondents’ subscriptions to takāful or insurance based on the number of years of operations.
an untapped market for takāful operators among this market segment, what is more important is the existent need to enhance consumers’ appreciation of takāful’s unique characteristics and its availability.

The following paragraphs provide the findings and insights on the behaviour of respondents who indicated they have insurance coverage (instead of takāful) for their corporations and organisations, as well as those who opted not to purchase any protection solution at all.

Respondents who chose insurance over takāful coverage. To understand the factors motivating the group of respondents who indicated having insurance coverage instead of takāful, the survey also included questions on possible reasons that drive such preference.

Table III.
Take-up rate of takāful coverage for the respondents who rated “Sharīʿah compliance status” as important (i.e. sample respondents) vis-à-vis all respondents

<table>
<thead>
<tr>
<th>List of risks exposure</th>
<th>Sample respondents (%)</th>
<th>All respondents (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Damages to business properties and premises because of fire, lightning, explosion, etc.</td>
<td>29</td>
<td>17</td>
</tr>
<tr>
<td>Loss of/damages to business properties and premises because of burglary/theft</td>
<td>29</td>
<td>17</td>
</tr>
<tr>
<td>Damages to machineries/equipment because of mechanical breakdown</td>
<td>37</td>
<td>22</td>
</tr>
<tr>
<td>Protection from legal liability upon employees’ injury/disease during employment</td>
<td>35</td>
<td>22</td>
</tr>
<tr>
<td>Protection from legal liability upon 3rd parties’ injury or damage to 3rd parties’ property</td>
<td>27</td>
<td>17</td>
</tr>
<tr>
<td>Loss of money/properties because of employee fraud</td>
<td>29</td>
<td>17</td>
</tr>
<tr>
<td>Loss of money/properties while in transit or being kept on business premises</td>
<td>29</td>
<td>17</td>
</tr>
<tr>
<td>Compensation for employees’ costs of general medical treatment, hospitalisation</td>
<td>24</td>
<td>16</td>
</tr>
<tr>
<td>Others</td>
<td>29</td>
<td>13</td>
</tr>
</tbody>
</table>
As shown in Figure 15, the results indicated “insurer’s positive reputation” as the most prominent factor that motivated the respondents to choose insurance (58 per cent of respondents chose this factor), apart from “the more effective claim procedures” (49 per cent of respondents chose this factor). “Familiarity with insurance” was also a strong factor (46 per cent of respondents chose this factor).

The above findings suggest that more needs to be done to strengthen market presence of takāful among the corporates. These measures include, among others, elevating consumers’ awareness on the value propositions of takāful (e.g. surplus-sharing) and increased offerings of customer-friendly products and services.

Respondents who opted not to purchase any protection solution at all. Out of the total corporations and organizations surveyed, around 35 per cent indicated that they do not currently own any takāful or insurance coverage. For this group of respondents, the survey further required them to state the reasons for not obtaining any coverage, from the preset answer options. The findings disclosed that perception of the importance of having a protection solution for their institutions is a more significant factor than weaknesses in the products or providers (i.e. the takāful operators and insurance companies). Adverse perception on the importance of takāful or insurance coverage was the most common reason cited by 36 per cent of this group of respondents as a deterrent against subscribing to any protection solution. Other reasons related to pricing and complicated procedures scored relatively lower frequencies, i.e. 26 and 22 per cent, respectively. Figure 16 provides further details of the responses.

Given the findings for (1) and (2) as above, it is pertinent for takāful operators to improve their competitiveness and elevate market presence to tap into this customer segment.

Method of securing takāful or insurance coverage
Respondents were required to share the sources from which they obtained takāful or insurance coverage. Their experience in selecting their existing takāful or insurance coverage (e.g. whether they compare terms of coverage across multiple providers) was also assessed via this survey. It is noted that heavy reliance on intermediaries, i.e. agent/broker, existed among the respondents, with 71 per cent of respondents using this channel to secure takāful or insurance coverage.

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reputation of insurance provider</td>
<td>58%</td>
</tr>
<tr>
<td>Easier claim procedures</td>
<td>49%</td>
</tr>
<tr>
<td>More familiar with insurance</td>
<td>46%</td>
</tr>
<tr>
<td>Cheaper premium</td>
<td>37%</td>
</tr>
<tr>
<td>Easier &amp; simpler application and documentation requirements</td>
<td>33%</td>
</tr>
<tr>
<td>Recommendation from agent/broker</td>
<td>28%</td>
</tr>
<tr>
<td>Flexibility in making changes to policy</td>
<td>23%</td>
</tr>
</tbody>
</table>

Figure 15. Ranking of factors for choosing insurance over takāful coverage
The significant role of intermediaries in finding the right protection solution for each corporation or organization was also consistent with the findings that 15 per cent of the respondents totally depended on their advice when securing takaful or insurance coverage. In addition, more than half of the respondents (58 per cent) indicated that they approached more than one company before securing their takaful or insurance coverage. The intermediaries’ role in facilitating such product comparison is certainly vital. Further details of the survey findings are as shown in Figures 17 and 18.

The results of the survey were further analyzed to find any linkage between the channels used vis-à-vis respondents’ awareness of availability of takaful or insurance. This is to measure the respondents’ level of reliance on intermediaries to obtain coverage when awareness and familiarity are already established. Surprisingly, it is found that despite being aware of the availability of takaful or insurance, 50 per cent of the respondents still employed agents/brokers’ services when securing takaful or insurance coverage. Only a small number of respondents (32 per cent) were getting takaful or insurance coverage directly from the takaful operators or insurance companies. This suggests that the role of
intermediaries is of utmost importance in general takaful. This is reasonable, as there is an
inbuilt expectation that intermediaries have certain expertise on the nature of risk exposures
of the corporations and organizations which may be unique to their particular activities.

Potential in small and medium enterprises
The study found that small and medium enterprises (SMEs, categorized according to the
definition of small and medium enterprises set by SME Corporation Malaysia), which make
up for approximately 45 per cent of the respondents, present good business prospects for the
takaful industry to venture into. Detailed profiles of the SME respondents are provided in
Tables IV and V.

Consistent with earlier findings on the awareness level of corporates towards takaful
coverage, SMEs too indicated relatively low awareness on availability of takaful. Only 68
per cent of SME respondents indicated awareness of takaful as compared to 80 per cent of
the overall survey respondents. The level of understanding on takaful among SMEs was
also relatively lower, as 46 per cent of the SME respondents highlighted their lack of
knowledge on details of takaful. Such low level of awareness naturally results in lower
subscription to takaful or insurance coverage among the SME respondents, as evident by
the survey results, which revealed that only 20 per cent of the SME respondents have
existing takaful or insurance coverage (as opposed to 37 per cent for the overall survey).

These findings on lower awareness and subscription to takaful or insurance coverage
(relative to the overall survey) are consistent with the observation that SME owners perceived
no direct benefit from participating in any of the takaful or insurance plans. As such, they are
reluctant to participate in a takaful plan, as it is deemed rather costly (Ibrahim et al., 2015).

Despite this finding, the survey revealed a strong potential for takaful to grow further
among SMEs, as 39 per cent of the respondents in this category indicated their willingness
to obtain takaful or insurance protection. Figure 19 summarizes the SMEs’ expressed
willingness to obtain takaful insurance coverage.

Figure 20 shows the factors considered by the SME respondents when obtaining
protection coverage. The findings revealed that SMEs’ considerations in obtaining
protection coverage do not differ much from other corporates. They too value the scope
of protection and affordability of the contributions/premiums as the main two factors when
obtaining coverage. Interestingly, contrary to the preference of other corporates, the SME
respondents highlighted easy access to the protection provider as a more important factor (90 per cent of the subgroup of respondents ranked it as moderately or very important) than other factors such as the quality of service and complexity of procedures. This clearly indicates that the demand for protection coverage from SMEs needs to be catered for in a slightly different way – i.e. through more direct interaction with the SMEs.

Consistent with this understanding, intermediaries (i.e. brokers and agents) were the distribution channel most used by SMEs in obtaining coverage (23 per cent of SMEs). This is reasonable given that such a channel allows closer and more interactive relations between the coverage providers and the SMEs. More information and education on the coverage can be given to SMEs by the intermediaries to cater for their specific business needs. Heavy reliance on brokers and agents is also apparent in SME sectors of other countries. The Boston Consulting Group (n.d.) in its article *Mining the untapped gold in SME commercial insurance* found that 35 and 14 per cent of SMEs in the UK and the USA, respectively reported that they did not know who their insurer was, or they listed their agent or broker as their carrier.

Another finding related to SMEs from the survey reinforces the need for more interaction to cater to specific protection needs for the SMEs’ businesses. On this point, a relatively lower subscription to *takāful* coverage related to fire was recorded among the SMEs compared to insurance coverage take-up (4 per cent *vis-à-vis* 96 per cent, respectively). This is despite the product’s availability in the market, it being offered by all general *takāful* operators.

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>No. of companies</th>
<th>(%)</th>
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<tbody>
<tr>
<td><strong>Size</strong></td>
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<td></td>
</tr>
<tr>
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<td>Small</td>
<td>56</td>
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<td>Medium</td>
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<tr>
<td>Non-manufacturing</td>
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<td>73</td>
</tr>
<tr>
<td><strong>Number of employees</strong></td>
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<td></td>
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<td>47</td>
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<tr>
<td>6-30 employees</td>
<td>51</td>
<td>46</td>
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<tr>
<td>31-75 employees</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>76-100 employees</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

**Table IV.**
Detailed profile of SME respondents by size, number of employees and business sector

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>No. of companies</th>
<th>(%)</th>
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<tbody>
<tr>
<td><strong>Business sector</strong></td>
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<tr>
<td><strong>Business sector</strong></td>
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<tr>
<td>Non-manufacturing</td>
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<td>29</td>
</tr>
<tr>
<td>Medium</td>
<td>7</td>
<td>6</td>
</tr>
</tbody>
</table>

**Table V.**
Detailed profile of SME respondents’ business sector – segregated into manufacturing and non-manufacturing sectors
Conclusion

Summary of findings

Key observations from the survey are as follows:

(1) Awareness on availability of takāful or insurance

The respondents were found to have a high level of awareness on the availability of takāful and insurance coverage. Greater awareness was noted on insurance compared to takāful among the respondents.

The majority of respondents indicated their willingness to obtain takāful or insurance coverage to protect their risks. However, only a minority of them had already obtained the coverage.

(2) Protection needs and current subscription to takāful or insurance coverage

The top three significant incidents chosen by the respondents as having the potential to affect their institutions and operations (business activities, business premise, staff welfare, etc.) were:

- **Scope of protection**
  - SMEs: 96%
  - All respondents: 97%

- **Affordability of premium**
  - SMEs: 93%
  - All respondents: 95%

- **Quality of service**
  - SMEs: 82%
  - All respondents: 90%

- **Easy access to insurer/takāful operator**
  - SMEs: 90%
  - All respondents: 89%

- **Complexity of procedures**
  - SMEs: 85%
  - All respondents: 86%
• physical damage to business properties;
• monetary loss caused by business interruption; and
• default on payment by clients.

The survey recorded a high subscription rate to takāful liability-related coverage, with protection being concentrated on medical and employee-related coverage. Subscription to takāful coverage was also relatively high on coverage related to fire products. Higher subscription to insurance than takāful coverage was noted across all named risk exposures, consistent with the higher level of awareness of insurance among the respondents. A strong positive correlation was found between the size and age of the respondents and their tendency to obtain takāful or insurance coverage across all types of risk exposures.

(3) Factors considered when obtaining takāful or insurance coverage

Respondents were generally indifferent to the Sharīʿah-compliance feature of protection coverage. In deciding whether to take up takāful or insurance coverage, respondents were highly influenced by scope of protection and affordability of contributions/premiums of takāful or insurance products. Among the subgroup of respondents who value the Sharīʿah-compliance feature of protection coverage, the majority still obtain insurance as their protection coverage across all risk exposures. This observation may signal less competitive terms and conditions of takāful products as well as limitations in the products offered by takāful operators that eventually led this subgroup of respondents to take up insurance instead.

The main factors that respondents identified for preferring insurance to takāful were insurers’ better reputation, more effective claim procedures and respondents’ familiarity with insurance compared to takāful.

The most significant factors cited as stopping respondents from getting any takāful or insurance coverage were the perception that protection coverage is not important for an institution as well as the high costs and complex procedures for obtaining coverage.

(4) Experience in securing takāful or insurance coverage

The study found that there is heavy reliance on intermediaries in accessing takāful or insurance coverage. Agents and brokers were the main channels used by the respondents to obtain coverage.

The survey findings also noted the potential of SMEs as a target market. The study revealed that this market segment presents favourable business opportunities for takāful operators to tap into, premised on their willingness to spend for takāful or insurance coverage despite having a relatively lower level of awareness on the availability of takāful.

Recommendations

To conclude, the findings from the survey indicate the criticality of initiating improvement measures at the takāful operators’ end to have more efficient business practices. There is also a need to elevate takāful operators’ market presence, which forms an integral element of remaining relevant and competitive in the general takāful and insurance market.

There is potential for takāful operators to reach out more to corporate clients and in particular to SMEs. Awareness and appreciation of the economic and social benefits provided through takāful protection can become key elements for takāful operators to attract
more corporates and organizations to subscribe to takāful. Information asymmetry among potential takāful participants could be minimized with enhanced educational and informative disclosure on takāful concept and application.

Takāful operators must be willing to invest and to align their marketing strategies as well as the types and scope of their products and services to suit the market segment they want to venture into. It is especially important for takāful operators not to solely rely on products’ compliance with Shari‘ah as their main selling point in their attempts to appeal to their targeted market segment. Rather, market competition shall be premised and based on features and scopes of products as well as quality of services offered, on top of affordable prices and easy access for customers. With comprehensive coverage, attractive product features as well as appropriate marketing, takāful operators can improve their market penetration and tap into underserved market segments such as those that emphasize having Shari‘ah-compliant coverage for their institutions. Optimized collaboration with agents and brokers is key to widening market outreach and building stronger market presence. Last but not least, this also warrants the need to improve the intermediaries’ and the takāful operators’ professionalism in servicing clients and securing long-term relationships with them.

This study is limited in that it focused on Malaysia’s experience. The findings are indicative (though they may not be conclusive) of the target segment as well as takāful industry as a whole. For future work relevant to the corporations’ and organizations’ sentiments towards general takāful, study of a similar focus group could be conducted to evaluate new trends and gather new insights for a more comprehensive study. The study can also be extended to other countries where general takāful products are offered.

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Further reading


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Preference shares: analysis of Sharī‘ah issues

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Abstract

Purpose – The purpose of this paper is to analyze the different features of preference shares from accounting and Sharī‘ah perspectives. It also aims to study Sharī‘ah issues arising from preference shares and to subsequently propose solutions for identified issues that will help in structuring Islamic preference shares.

Design/methodology/approach – The paper uses a qualitative method by analyzing relevant documents and literature to understand the subject matter and Sharī‘ah-related issues.

Findings – The paper finds that several features of conventional preference shares, such as capital guarantee, loss sharing disproportionate to capital contribution, fixed profit, profit guarantee and waiver of rights before realization of profit, make them a Sharī‘ah non-compliant instrument.

Research limitations/implications – The paper is conceptual in nature; however, it provides directions for future empirical research.

Originality/value – The paper provides a practicable solution to structure Sharī‘ah-compliant preference shares.

Keywords Equity, liability, debt, capital guarantee, preference shares

Paper type Research paper

Introduction

From their original feature of mere preference in dividend distributions (Evans, 1929), preference shares have evolved significantly to the present time with a range of other rights granted to their holders. In financial reporting based on International Financial Reporting Standards (IFRS), a preference share can be classified as an equity or a liability instrument, or even as a compound instrument, comprising both equity and liability components. These classifications depend on the rights of preference shareholders and the obligations of the issuing entity, and there is no one classification that fits all. One common feature is that preference shareholders have a prior claim over ordinary shareholders on the issuing entity’s distributable earnings and on net assets at the time of liquidation (Bursa Malaysia, 2017), but they are subordinate to bonds and other types of debts. The preferential rights over ordinary shares raise concerns from a Sharī‘ah standpoint about the classification and acceptability of preference shares.
Features of preference shares

The features of preference shares are identified based on the rights given to preference shareholders. For example, the features identified from the prospectuses for preference shares issued by Allianz Malaysia Berhad (2010), Dolomite Corporation Berhad (2012) and Insas Berhad (2014) include cumulative/non-cumulative, redeemable/irredeemable and convertible/non-convertible. Accordingly, the rights granted to preference shareholders are grouped into three: dividend rights, redemption rights and conversion rights.

This paper identifies the primary factor that results in a liability classification in an IFRS-based financial reporting. This is if the issuing entity has a contractual obligation to deliver cash or another financial asset to another entity (i.e. in this case, to preference shareholders). For an equity classification, the issuing entity must have the unconditional right to deny any dividend payment or capital redemption (IFRS Foundation, 2016).

This paper also addresses convertible preference shares. The most important issue here is whether conversion involves a fixed or variable number of the entity’s own equity instruments. The paper finds that conversion into a fixed number of instruments results in an equity classification in IFRS-based reporting, whereas conversion into a variable number of instruments results in a liability classification (IFRS Foundation, 2016).

Findings based on Sharī'ah analysis of preference shares

This paper analyzes the Sharī'ah issues arising from preference shares based on two premises: whether the underlying contract is an equity contract or a debt contract. The rulings of mushārakah (partnership) are applied when deliberating on preference shares as an equity contract, and the rulings of qardh (loan) are applied when deliberating on preference shares as a debt instrument.

Preference shares as equity contracts

Five Sharī'ah issues are identified in the premise that preference shares are equity contracts. These are:

1. capital guarantee;
2. loss sharing disproportionate to capital contribution;
3. fixed profit;
4. profit guarantee; and
5. waiver of right prior to realization of profit.

The capital guarantee happens in the following situations:

- *If preference shares are redeemable at the issue price*: The redemption right is agreed upon at the time of subscription to the preference shares and puts the issuer under liability to pay back the full amount of the invested capital to the preference shareholders upon redemption.

- *If preference shares are converted into a variable number of ordinary shares equal to the value of the issue price*: Because of this conversion, even though the preference shareholders will not get back their invested capital in the form of cash, they will get ordinary shares that are equal to the value of their invested capital.

Loss sharing disproportionate to capital contribution arises when preference shareholders have the privilege of claiming their capital before ordinary shareholders at the time of liquidation and winding up. Based on this prioritization, ordinary shareholders may not
receive any of their capital back or may receive only part of it. This is because it is subject to the availability of liquidation proceeds after settling all payments to the prioritized parties, i.e. creditors and preference shareholders.

The fixed dividend rate provides a contractual or constructive guarantee that a profit at that rate will be distributed to preference shareholders. The guarantee is contractual if the preference shares have a cumulative feature and constructive if they have a non-cumulative feature.

The element of profit guarantee exists if the preference shares have a cumulative feature. With this feature, if a company does not pay a dividend because of financial distress, liquidity problems, plans for future investment or any other reason, the amount of unpaid dividends gradually builds up until it is paid to the shareholders. Any accrued but unpaid dividends of preference shares with a cumulative feature must be paid to the preference shareholders upon redemption.

The waiver of right to profit by ordinary shareholders occurs prior to profit realization when they consent to the issuance of preference shares at a general meeting. Any profit from investment of this new capital is yet to be generated at that point in time.

Preference shares as debt contracts
The main Shari‘ah issue identified in the premise that preference shares are debt instruments is the existence of ribā (interest). A strict Shari‘ah prohibition applies to guaranteeing any return over the debt principal amount. This issue is particularly pertinent in the case of cumulative preference shares.

Proposed solutions for structuring Shari‘ah-compliant preference shares
After identifying the Shari‘ah issues related to preference shares, the paper concludes that the most conventional preference shares are Shari‘ah non-compliant, especially because of the features of capital guarantee and fixed return. The above-mentioned Shari‘ah issues must be avoided to structure preference shares in a Shari‘ah-compliant manner. The paper proposes the following recommendations:

- To avoid the issue of capital guarantee in redeemable and convertible preference shares, the redemption price must be based on the market price or a price agreed upon at the time of redemption. For the conversion, price must be based on a fixed number of preference shares to a fixed number of ordinary shares. This is because the value of ordinary shares at the date of conversion is not necessarily equal to the capital injected upon subscription to the preference shares.

- To avoid loss sharing disproportionate to capital contribution, ordinary shareholders can give a conditional waiver of right to the preference shareholders. This waiver of right can only be confirmed at the point of winding up or liquidation, not at the outset when issuing the preference shares.

- To avoid a fixed profit rate, the distribution between ordinary and preference shareholders can be based on an agreed-upon profit sharing ratio up to a ceiling amount, beyond which a specified amount can be given to the preference shareholders.

- To avoid a profit guarantee, the dividend payment must be based on realization of profit. Moreover, accumulation of dividends based on a pre-determined rate must be avoided. However, any declared but unpaid dividends can be accumulated and become part of the issuer’s liabilities. This is because, upon declaring a dividend, the issuer has a legal obligation to pay it. In this case, the debt can be paid in the following year or can be paid upon redemption by including the amount (if any) in the redemption price.
Regarding waiver of the right to profit prior to its realization the study prefers the view that permits upfront tanāzul (waiver) that is done after the existence of the sabab (cause) of the right, even though the right itself does not yet exist (Badri and Mohamad, 2014). Thus, even though the profit is not yet realized upfront tanāzul is permitted because the cause already exists, i.e. the mushārakah contract has been executed. However, the study also proposes other solutions: a promise to waive the right and conditional tanāzul. These are alternatives to upfront tanāzul for those who consider upfront tanāzul impermissible even when the cause of the right already exists.

In terms of the issue of ribā arising in preference shares (when treated as liability), there is no way to make them Sharī’ah-compliant. Therefore, the study concludes that preference shares should be structured based on the mushārakah contract and not on the qarḍ contract.

Conclusion
This paper has discussed preference shares from both accounting and Sharī’ah perspectives. It finds that in IFRS-based financial reporting, preference shares can be classified as a liability, equity or hybrid instrument.

When preference shares are classified as equity, the principle pertaining to mushārakah is observed. When preference shares are categorized as debt/liability instruments, the Sharī’ah ruling pertaining to debt is analyzed.

This paper finds that there are different types of preference shares having different and unique features. Thus, it is not accurate to simply generalize all types of preference shares as either equity or loan without analysing the specific features embedded in each type. This paper also finds that most preference shares are not compatible with the Sharī’ah ruling for either mushārakah or loan.

It is found that the combination of principal and profit guarantee, as well as fixed guaranteed return embedded in most conventional preference shares, makes these financial instruments similar to conventional loans. The paper is of the view that a combination of loan features and equity features changes the instrument to a liability. This is the reason for the authors’ view that conventional preference shares having those primary loan features are generally classified as a liability. In addition, from the Sharī’ah perspective, this paper finds that a single loan feature is sufficient to classify any preference share in the loan category.

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Abstract

Purpose – This paper aims to address the financial reporting dimensions of intangible assets with specific reference to International Accounting Standards (IAS) 38 as well as relevant International Financial Reporting Standards (IAS 38 exclusion) that are embedded within intangible assets. These have implications for Islamic financial assets with identifiable and measurable intangible components.

Design/methodology/approach – The study uses the qualitative research method by way of interviews followed by focus group discussions with professional accountants/accounting academics and Shari’ah scholars/advisors from academia, the industry and regulatory bodies. Analysis of relevant literature is made to understand the subject matter and Shari’ah-related issues.

Findings – The study observes that the accounting dimensions of tangible assets are generally consistent with Shari’ah requirements. However, significant variation arises when the dimensions of intangible assets are represented in financial assets.

Research limitations/implications – The paper presents an exploratory in-depth analysis within the context of intangible assets as specified in IAS 38.

Originality/value – The paper elucidates the comparative accounting dimensions and Shari’ah requirements in reporting financial assets.

Keywords Financial reporting, intangible assets, Islamic finance, financial assets

Paper type Research paper
Introduction

The Sharīʿah requirements regarding the transferability of intangible assets include a clear transfer of title and the need for the asset to adhere to Sharīʿah-compliance requirements, which include avoidance of gharaar (uncertainty), maysir (gambling) and concealing knowledge. The avoidance of gharaar is twofold: parties must know exactly what the product is as well as its precise value. However, Khattak et al. (2015) found that there is a lack of clarity with regards to rights and remedies associated with intangibles in some Islamic jurisdictions.

Bouheraoua et al. (2013) have also found important Sharīʿah issues related to intangible assets such as gharaar fāḥish (excessive uncertainty) in the identification and determination of the intangible assets due to their non-physical attributes and the probabilistic nature of their future benefits. They have identified two Sharīʿah views on this issue. One view does not recognize probable future economic benefits until they actually exist, to ensure the protection of property and avoid disputes among the contracting parties. The other view recognizes probable future economic benefits when the probability of their existence is preponderant.

The involvement of intangible assets in the structuring of Islamic financial products has raised emerging pertinent reporting issues of substance and form of the financial transactions. The financial reporting issues present in the accounting of intangible assets require specific accounting policies and treatment that consider Sharīʿah requirements on permissible, measurable, separable and tradable dimensions. This study intends to explore the reporting dimensions of intangible assets in accordance with International Financial Reporting Standards (IFRS) and the relevant Sharīʿah requirements.

Objectives of the study

To confirm and seek the consensus of expert opinions for the purpose of facilitating the formulation of appropriate policy and effective strategy for reporting intangible assets in the Islamic financial services industry, the principal objectives of the study are designed as follows:

- to highlight issues on specific financial reporting requirements on intangible assets as specified in IAS 38 Intangible Assets and relevant standards (IASB, 2016) with reference to Islamic financial transactions; and
- to elicit professional accounting and Sharīʿah expert opinion and views on the risk exposures of adopting financial reporting requirements of financial assets as economic consequences of Islamic financial transactions.

Research methodology

This study adopts a multi-method approach of content analysis of IAS 38 as well as interviews and focus group meetings with professional accountants, accounting academics and Sharīʿah scholars/advisors. Figure 1 highlights the multi-method approach.

A critical review of IAS 38 was done to highlight the pertinent dimensions of intangible assets as specified by the standard. This is followed by an in-depth interview of an audit partner familiar with Islamic banking and finance as well as two separate focus group discussions with professional accountants and accounting academics followed by regulators and Sharīʿah academics/scholars/advisors with significant engagement in the Islamic financial services industry in Islamic banking, takāful and Islamic capital markets. Similar interview/focus group questions were disseminated. Additional clarifications were sought.
Findings from interviews and focus group discussions
Based on the themes derived from interviews and focus group discussions, the responses are elicited and summarized as follows:

Asset as economic resource and its value as economic consequence to investors
Both the accounting and Sharī‘ah focus groups recognize assets as economic resources and acknowledge that the primary reporting purpose is to provide information to both investors and creditors and indirectly to stakeholders. Hence, economics precedes social choice in reporting based on the economic consequences in terms of asset valuation.

Intangible as non-physical substance from accounting and Sharī‘ah perspectives
Intangible as a concept in accounting and Sharī‘ah is agreed on by members of both focus groups to represent non-physical substance. However, variations arise in terms of application of the intangible concept as an asset. Sharī‘ah scholars view financial and monetary assets as intangibles.

Importance of possession and control of intangible assets
Both the accounting and Sharī‘ah focus groups agree on the importance of possession and control of the asset (māl). The Sharī‘ah focus group distinguishes an asset (māl) from ownership (mīlīk) as represented and agrees that in essence, property fulfills both conditions. In accounting representation, assets include both equity and liability (obligations) claims. Hence,
net assets as residual claims are proximate to investors' interest (ownership). This is consistent with computation of net worth in zakāh (almmsgiving), which is represented by net assets.

Separable as a pertinent dimension to identify an intangible asset
The process of identification of the intangible component relates to peculiar technical or legal constructs or specifications such as recipe, patent, etc. Both focus groups agree on the need for such constructs or specifications to be identifiable. However, for the identifiable component to be reported as an intangible asset, “separable intangible component” as a dimension becomes critical. In any case, it is initiated by a management decision to identify it as a separate component and is subject to whether it is separable from tangible assets. The materiality of the intangible component is highlighted as one of the possible considerations for the need to separate.

Transferable as a pertinent dimension to recognize an intangible asset
The transferable dimension of the intangible component is pertinent to enable recognition of a separable intangible component as an intangible asset. This is significantly deliberated in both focus groups to consider both dimensions peculiar to intangibles if reported as a separate tangible asset balance sheet item.

Contractual right represents both separable and transferable dimensions
In the final analysis, due to the focus of financial reporting, the economic consequences of transactions representing contractual rights and obligations, both the accounting and Sharī’ah focus groups agreed that contractual rights are paramount to recognition. These will be consistent with representing both separable and transferable dimensions. In Sharī’ah, both rights (ḥaqq) to the asset (māl) and rights to usufruct/beneficial use of the asset (manfa’ah) are recognized. In the case of usufruct, the right to benefit could be attached to a tangible asset and hence recognized from the reporting of tangible asset lease value. On the contrary, if the intangible asset is a significant separable and transferable component, both the rights to possess, control and benefit as an asset (māl) as well as rights to usufruct (manfa’ah) should be reported separately from tangible assets. Sharī’ah-compliance tests on the permissibility of activities, legitimacy and validity of contracts as well as the avoidance of usury and gharar would then be consistently applied to both the tangible asset and its intangible component or asset.

In a separate discussion of financial instruments as investments or receivables and not intangibles, the Sharī’ah focus group deliberated on the essence of intangibles being represented as monetized assets. Some sukūk issuances comprise a material (i.e. substantial) intangible component, but it is represented as financial instruments and not intangible assets. This raises an accounting issue because financial instruments are covered by IFRS 9 Financial Instruments, whereas intangibles assets are covered by IAS 38. Hence, the intangible component in such sukūk issuances may not be sufficiently disclosed in the financial statements. However, the Sharī’ah scholars based their judgment exclusively on the relevant sukūk information memos, which only highlight the intangible component at the issuance stage (for initial recognition). Subsequent measurement and disclosures only relate to contractual rights to receive, or obligations to disburse, cash flows as per the financial instrument standard. Both focus groups deliberated the question of whether additional disclosures on the intangible component that impacts the value of financial securities should be part of risk reporting and hence be advocated.
**Measurable value with certainty and management option/choice for cost or valuation model**

On initial and subsequent measurement of tangible and intangible asset value with certainty, both the accounting and Sharī'ah focus groups acknowledged the economic consequences of valuation of investors and creditors' interest. Supplementary information on the value of assets in the interest of third parties or stakeholders needs to be presented as separate disclosures. The choice of subsequent fair value measurement method(s) may require Sharī'ah scrutiny, especially on intangible assets affecting other external third-party interests.

**Sufficiency of intangible presentation and disclosure as per IAS 38**

IAS 38 only provides specific guidance on the presentation and disclosure of intangible assets. If the intangible components of a tangible asset are not treated separately, then they lack specific guidance under this standard. Hence, management discretion whether to quantify intangible assets raised concerns on the implications of social choice relating to public or stakeholder interest. The choice of reporting something as an intangible component in disclosure notes or as an intangible asset presented in the balance sheet item needs to be substantiated. Furthermore, risk-based and Sharī'ah-compliant disclosures on intangible assets as well as material intangible components of tangible assets are lacking. This is especially so in the issuance of financial instruments such as shares or ṣukūk. The risk characteristics of an intangible asset, or the intangible component of a tangible asset, may change over its lifecycle. This may pose challenges in reasonable valuation and disclosure, which in turn substantively complicate periodic monitoring of Sharī'ah compliance.

**Conclusion**

This paper concludes an interesting phenomenon on how professional accountants apply the provisions of IAS 38 and its exclusion on intangible assets and the views of Sharī'ah scholars in line with related requirements in Islam. The professional accountants' views appear to be premised on economic choice consideration. In other words, they are investor-centric. Sharī'ah scholars, on the other hand, are concerned with the social choice consideration of compliance and stakeholder interest. Though both accountants and Sharī'ah scholars agree on the key dimensions of intangible asset reporting, variations arise due to a broader perception of intangible assets as including financial instruments and monetized assets. The central concern is the effect of this treatment on the contracting parties who rely on the sufficiency of the information disclosed for their informed decisions. Economic decision usefulness as propagated by the financial reporting standards in reporting intangible assets would require additional disclosures on the intangible component of tangible assets in terms of Sharī'ah compliance and risk-based disclosures.

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Sharīʿah non-compliant assets as rahn (pledge) in Islamic banking products: a fiqhī perspective

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Abstract
Purpose – The purpose of this study is to present a framework regarding the use of Sharīʿah non-compliant assets as rahn (pledge) and to provide the Sharīʿah analysis on the application of numerous collateral instruments, including financial assets such as shares, unit trusts, current accounts and investment accounts which are Sharīʿah non-compliant.

Design/methodology/approach – The study adopts a library-based approach to examine the concept and requirements of rahn, deliberate the classification of Sharīʿah non-compliant assets and delineate the Sharīʿah views on the use of Sharīʿah non-compliant assets as pledges. It also examines the various forms of pledge available and offered in the market using document analysis as well as through discussion with industry practitioners.

Findings – In general, the study concludes that Sharīʿah non-compliant assets, either due to their essence or due to the means of acquisition where there is no ownership from Sharīʿah perspective, cannot be used as rahn. This study also provides the Sharīʿah analysis on the use of modern instruments such as shares, unit trusts, current accounts, investment accounts and insurance policy as pledges.

Originality/value – The paper provides a reference source for regulators in formulating an appropriate policy and framework on Sharīʿah-compliant collateral; Sharīʿah committees of Islamic financial institutions in arriving at Sharīʿah decisions on collateral; and industry practitioners in establishing internal policies and procedures on collateral.

Keywords  Collateral, pledge, rahn, Sharīʿah non-compliant asset

Paper type Research paper

Introduction
Collateral is an important tool that banking institutions use to manage the risk of customer default. In such an event, the bank may claim from the collateral to recover payment of the customer’s outstanding obligation. Practically, collateral may be either in the form of tangible assets, such as real estate and vehicles or financial assets such as bonds, ṣukūk and
shares. Collateral is normally charged to secure a financing facility. Over the past decade, Islamic banking products have witnessed a remarkable development, shifting from plain vanilla products to more sophisticated and exotic structures and features. This trend has been accompanied by the introduction of numerous unprecedented collateral instruments, including financial assets such as shares, unit trusts, current accounts and investment accounts. These may raise issues, particularly if they involve Sharīʿah non-compliant elements.

Against this background, there is a need for Sharīʿah investigation of the use of Sharīʿah non-compliant assets as collateral in the modern banking arena. A cursory review of the literature finds that there is lack of research on this aspect, perhaps due to the complexity of the issue and the fact that it is a relatively new area.

Research objectives
The study aims to achieve the following research objectives:

- to discuss the concept of rahn (pledge) from the fiqh perspective;
- to deliberate the use of Sharīʿah non-compliant assets as rahn; and
- to assess the application of Sharīʿah non-compliant assets as pledges in Islamic banks.

Research methodology
The study is library-based, benefitting from various classical sources, Qurʾānic texts and Prophetic traditions to reach a cohesive understanding of the Sharīʿah position pertaining to the use of prohibited assets as rahn. It also looks into fatwas, resolutions, standards and other related literature. The study further examines the various forms of pledge available and offered in the market using document analysis as well as discussion with industry practitioners.

Sharīʿah requirements of rahn
The requirements of rahn in Islam follow the conditions of the asset in a sale contract: it must be recognized by the Sharīʿah as valuable and be existent, identifiable, deliverable and owned by the pledger. The reason for these requirements is that the function of a pledge is to settle the outstanding obligation by selling it in the event of debtor default. This is only possible if the pledge is legally recognized subject matter of the sale contract (Ibn Qudāmah, 1388H, p. 4/253). Any item which is permissible as the subject matter of a sale is also permissible as collateral. On this basis, jurists developed the famous legal maxim which states, “What is permissible to be sold is also permissible to be pledged” (al-Zarkashī, 1405H, p. 3/139). Inversely, a Sharīʿah non-compliant asset does not qualify to be the subject matter of rahn. The Rahn Exposure Draft issued by Bank Negara Malaysia (BNM) clearly states that the subject matter of the rahn contract shall be collateral (marhān) that is recognized by the Sharīʿah (BNM, 2017, p. 5). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in its Sharīʿah standard no. 39 also requires pledges to be Sharīʿah compliant. It states: “The mortgage asset should be a Sharīʿah-permissible property. It should also be well specified (through pointing, naming or description) and be possible to deliver” (AAOIFI, 2015, p. 970).
Initial findings

The study finds that Shari’ah non-compliant assets in relation to their use as rahn are categorized into two major types: first is the asset prohibited in its essence (li dhātih) and second is the asset prohibited due to an external reason, namely, the means of its acquisition (li kasbīh). The former refers to an asset that the Shari’ah has prohibited due to an essential attribute (waṣf). In other words, it is an asset prohibited in its essence because it is harmful or unclean. This category includes pork, wine and other impure items. Jurists unanimously agree that these items cannot be used as a pledge. The second category of Shari’ah non-compliant assets is further subdivided into four classes, namely:

1. an asset acquired without the consent of the owner;
2. an asset acquired with the consent of the owner through a void (bāṭil) contract;
3. an asset acquired with the consent of the owner through a voidable (fāsid) contract; and
4. an asset acquired with the consent of the owner by unlawful possession without the use of any nominate contract.

For a Shari’ah non-compliant asset acquired without the consent of the owner, or with the consent of the owner but via a void (bāṭil) contract or by unlawful possession without any contract such as by bribery or gambling, the study concludes that it is not permissible to accept a non-monetary asset as rahn due to the absence of ownership. However, if the asset is monetary, there are two different scenarios:

1. if the money is not commingled with other money, it is not permitted for use as rahn; and
2. if the money has been mixed with other money, it is permissible to accept it as rahn up to the limit of the amount of the ḥalāl (permissible) portion.

As for the Shari’ah non-compliant asset acquired through a voidable (fāsid) contract, the study found that the asset can be used as rahn, according to the Hanafi school, provided that the contract has undergone rectification or the purchaser has taken possession of the asset with the seller’s consent.

Based on the established Shari’ah framework presented in the paper, the study concludes that a conventional fixed deposit can be used as a pledge limited to the principal amount. In this regard, the Shari’ah Standards and Operational Requirements of Murabahah issued by BNM also states that an interest-bearing debt-based asset such as a conventional fixed deposit certificate may be used as collateral provided the collateral is valued up to the principal amount (BNM, 2016, p. 17).

The study also concludes that a conventional bond can be used as a pledge limited to the issuing price of the instrument. The Exposure Draft of Rahn clearly states: “Where a Shariah non-compliant financial asset is used as a collateral, the collateral value must be limited to the principal amount of the financial asset” (BNM, 2017, p. 5).

A Shari’ah non-compliant unit trust may also be utilized as a pledge capped at the value of the investor’s initial investment and subsequent top-ups.

Furthermore, the shares of companies with mixed assets that comprise Shari’ah-compliant and Shari’ah non-compliant assets may be accepted as rahn provided that the core business activities of the company are Shari’ah-compliant. A share which comprises mixed activities can also be used as rahn valued up to the amount of the Shari’ah-compliant portion only. The shares of a company not meeting the financial ratio benchmark may also be utilized as rahn.
An insurance policy can be accepted as a pledge limited to the total amount of premiums the policyholder has paid. This is because the insurance company does not have a right to the premium paid by the policyholders, whereas the policyholders have no right to the coverage. Therefore, the policyholder cannot use the insurance policy as a pledge due to the absence of ownership rights associated with it. However, he can use the benefit of the insurance policy as a pledge up to the amount of the premiums he has paid.

Conclusion
This framework has been developed based on the fundamental Sharī'ah ruling on rahn. Other considerations, such as maslīlahah (benefit/interest), ḥājah (need), dharī'ah (means), that may form a basis to depart from its original ruling are put aside and left to the discretion of the respective Sharī'ah authorities on a case-by-case basis. The paper acknowledges the possible gap between the established framework and the prevailing practices. This is particularly true because the paper only deals with the issue of collateral that has the characteristics of a pledge. Further studies may examine each and every form of collateral available in the market such as debentures, charges, assignments, securities and others.

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Contra trading in Bursa Malaysia Securities Berhad: a Sharī‘ah and legal appraisal

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Abstract

Purpose – The purpose of this paper is to analyze the practice of contra trading in Bursa Malaysia Securities Berhad. Through a critical examination of the practice, it aims to discuss the issues from the angles of Sharī‘ah and Malaysian common law.

Design/methodology/approach – The paper uses a qualitative research methodology. The information on the practice of contra trading is obtained through the Bursa Malaysia Securities Berhad’s website and literature as well as series of meetings and discussions held with Bursa Malaysia Securities Berhad. In comprehending and dissecting the Sharī‘ah and legal issues, classical along with contemporary Sharī‘ah literature including local and international Sharī‘ah advisory bodies’ resolutions and standards have been referred to. The Sharī‘ah analysis of these issues is further supported by reference to the statute and by-laws of Bursa Malaysia Securities Berhad as well as other related legal literature.

Findings – This paper finds that contra trading involves a real sale and purchase of shares; the shares are not taken into the possession of the contra trader, neither physically nor constructively; the liability of shares is not transferred to the contra trader; though the practice of profiting in contra trading may contradict the prohibition on profiting without bearing liability, the permissibility of contra trading could still be argued from the contextual approach of public interest (maṣlahah) and needs (hājah); and contra trading is not gambling.

Research limitations/implications – This paper is limited in its analysis to only Sharī‘ah and legal perspectives. It does not cover a thorough empirical and quantitative investigation that would measure the extent of the public needs for contra trading and the real benefits that contra trading brings about to the society in the long run. Such studies will further demonstrate whether contra trading deserves a relaxation from the strict Sharī‘ah ruling thus affirming the issue of permissibility of contra trading. Moving forward, this paper recommends ways to address the predicaments faced in the contra trading practices as well as other related legal literature.

Originality/value – This paper provides an in-depth investigation of the practice of contra trading at the Bursa Malaysia Securities Berhad from the angles of Sharī‘ah and common law.

Keywords Legal, broker, exchange, contra trading, shares

Paper type Research paper

Introduction

Contra trading refers to an activity that allows a buyer to contra or offset its obligation to purchase shares with its broker before the settlement/maturity of the contract. The benefit of
contra is that it enables the buyer to exit the contract earlier. The end result of contra is the netting off between the amount the broker has to pay to the original seller for the price of the shares and the amount the broker receives from the new buyer for the price of the shares.

Although contra trading is claimed to facilitate the efficiency and liquidity of the market, the manner in which it is being carried out attracts Shari'ah scrutiny. The need to investigate the compliancy of contra trading practices is timely as at present the Shari'ah Advisory Council of Bursa Malaysia has yet to issue any resolution on its permissibility.

**Shari'ah and legal issues affecting contra trading**

This paper analyzes and discusses seven issues that are found in the practice of contra trading at Bursa Malaysia. The issues relate to:

1. the shares' ownership before the Settlement Day;
2. whether the contra transaction is a pseudo or real sale of asset;
3. the possession of the sold shares (qabḍ al-mabiț – قبض المبيع) and transfer of liability (intiqāntiqāl al-ḍamān – إنتقال الضمان);
4. deferment of both counter-values (ta’jīl al-badalayn – تأجيل البدلین);
5. selling something before taking it into possession (bay’ al-shay’ qabla qabdihi – بيع الشيء قبل قبضه);
6. profiting without bearing liability (ribhu ma lam yaḍman – ربح ما لم يضمن); and
7. gambling (muqāmarah/maysir – المقامرة/المسر).

The discussion of the first issue is based on the question of whether, at the time the buyer enters into the contra trading, he is already the real owner of the shares and thus entitled to sell them. From the Shari'ah perspective, for the shares to be transferred and owned by the buyer, the transaction that is evidenced by the Contract Note must fulfill the requirements of a valid contract. The underlying principle is that ownership of the subject matter of a sale is transferred to the buyer upon the conclusion of a sale contract regardless of whether the subject of sale has been delivered to the buyer or the price has been paid to the seller (al-Mawsū‘ah al-Kuwaytiyyah, 9/36). The discussion of the issue of ownership refers also to the position of the law that raises some predicament with respect to the limitation of the right of the buyer over the shares.

The second issue deals with the legal-Shari'ah conundrum about the status of the buyer/contra trader as the owner of the shares during the onward sale. The law clearly stipulates that true and ultimate beneficial ownership is with the person in whose name the shares are duly registered with the Central Depository. This paper is, however, of the view that from the Shari'ah perspective the contra trader is the real owner of the shares that he onward sells to a third party. The purchase transaction done by the contra trader fulfills all the pillars and conditions of a valid sale and purchase transaction.

On the issue of possession, this paper is of the view that shares represent one's ownership of the capital of the company and the rights associated with it; thus, owning shares can never entail physical possession. Therefore, in the case of buying and selling of shares, the possession involved is argued to be constructive possession. The question that follows this proposition is whether the purchaser has constructively taken the shares into his possession on the transaction day, i.e. T + 0. In general, constructive possession is attained by removing impediments to the buyer accessing the commodity (tahlīlah) and enabling him to deal with it as he wills (tamkīn). Therefore, the liability for loss of the asset will transfer to the person who has taken the asset into his constructive possession (Islamic Finance
Knowledge Repository, 2017). Based on this, the paper argues that “takhliah” and “tamkîn” as mentioned by jurists for constructive possession are not fulfilled before the delivery of the shares on T + 3, as the buyer has not been given access to the shares or any power over them, except the buyer’s ability to sell them. A mere legal right to sell the shares and to gain profit from the sale does not suffice to constitute constructive possession for the buyer when the benefits and liabilities of the asset (i.e. the underlying company) are still vested with the original seller. Additionally, the paper argues that being legally allowed to sell an asset and being liable to its price movement does not at all mean that the liability of the asset has actually transferred to the buyer.

The fourth issue on the deferment of both counter-values (ta’jil al-badalayn) involves the discussion of gharrar (uncertainty) due to the non-delivery of counter-values in the contract session. The question that is asked is whether contra trading involves the element of ta’jil al-badalayn. The paper is of the view that in ta’jil al-badalayn the issue is not about when the transaction takes place but, rather, about when the subject matter is delivered and the price is settled. This will only happen and appear in the accounts of both parties three days after the transaction. Thus, the three-day delay for the delivery of both counter-values could be evidence for the conclusion that share trading does involve ta’jil al-badalayn. However, the paper takes the view of the Mâlikî School that the three-day deferment can be deemed as minor and tolerable (Ibn Rushd, 1988, 2:28). In addition, the three-day deferment in shares trading has been accepted as the international industry convention (‘urf ahîl al-sanâ‘ ah). That could constitute a strong basis of need (hâjah) that justifies a relaxation of the general prohibition of ta’jil al-badalayn.

On the fifth issue, selling something before taking it into possession, the discussion turns on whether shares are considered a food item. Obviously, they are not. If so, shares would fall outside the prohibition of selling food before taking it into one’s possession.

The sixth issue deals with Prophet Muhammad’s (ﷺ) prohibition on taking profit from something for which one does not bear liability (al-Nasâ‘î, 1986). The question that leads the discussion is whether the buyer is entitled to the profit made from the contra trading (prior to taking possession of such shares and when the buyer has yet to bear any liability for them). Despite the practice in the market that allows the contra traders to profit, the paper finds reason to question this norm due to the governing trading law and the cash settlement procedures. In the event of failure to deliver the shares, the rights, entitlements and liabilities are accorded based on the owners’ names registered in the shares registration record. The buyer (contra trader) is not a registered shareholder/beneficial owner of the shares; thus, he will not be able to benefit from the rights and entitlements arising from the shares nor be liable for the liabilities arising from them. Therefore, making profit from contra trading is viewed as prohibited.

The discussion on the last Shari’ah issue, gambling, is based on the resolution of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shari’ah standard no. 21 on financial papers that allows for speculative trades (AAOIFI, 2015). The paper further argues that contra trading is not between two parties betting on a same bet, which will end up with one of them winning and the other losing. Instead contra trading is about selling an asset at the market price, whereas the other party may want to keep the shares for a long investment because the price may keep on increasing.

Research findings
This paper finds that contra trading involves a real sale and purchase of shares. It further finds that from the Shari’ah perspective, irrespective of the legal requirement for the share's legal ownership, at the time when the contra trade is executed, the contra trader is the real
owner of the shares that he onward sells to a third party. The reason is that the purchase transaction done by the contra trader fulfils all the pillars and conditions of a valid sale and purchase transaction.

With regards to the issue of delivery and possession of shares as well as the transfer of liability of shares during the onward sale, contrary to the stance of AAOIFI, this paper finds that the shares have not been taken into the possession of the contra trader, either physically or constructively. This paper further finds that the liability associated with the shares has not been transferred to the contra trader.

On the issue of deferment of both counter-values, which many scholars as well as AAOIFI do not allow, this paper finds that it is not a fundamental issue in Shari‘ah. It is further viewed that the deferment of three days can be considered as minor, hence tolerable. Related to this issue is the question of possession and transfer of liability in the sale of shares before possession. Based on the views of many Muslim scholars that allow selling before possessing the sold item so long as the item is not food, the paper concludes that selling shares before the buyer possesses them is allowed.

In relation to the issue of profiting without bearing liability, the paper finds this practice to be clearly prohibited by Prophet Muhammad (ﷺ). Therefore, the practice of profiting in the contra trading, when the shares are yet to be in the buyer's possession and when liability of the shares has yet to be transferred to him, transgresses this prohibition. Having said that, this paper argues that the permissibility of contra trading could still be argued from the contextual approach of public interest (maṣla/ḥ and need (ḥājah).

Finally, the paper concludes that there is no element of gambling in contra trading. Gambling allows one party to gain at the expense of the other, and this is not so in the case of contra trading. In contra trading, the broker will always make a profit from the brokerage fee and not the price movement, i.e. the chargeable fee when a trader purchases shares and executes a contra trade, regardless of whether the onward sale is profitable or bears a loss. The sale itself could also be profitable to all the sellers, including the original seller and the onward sellers (contra traders), if the price of the shares keeps on increasing and also to the ultimate buyer who decides to keep the shares and does not onward sell them. If the price decreases and the contra trader makes a loss, it does not amount to gambling either, as it is a normal risk that any trader has to take.

**Conclusion and recommendations**

The paper has deliberated in length the issues of contra trading, analyzing them from the angles of Shari‘ah and common law. The findings of the paper reveal that there are some identified issues in contra trading that require future in-depth deliberation. On that basis, the paper makes two recommendations.

First, it recommends a change in the formula of cash settlement for failed contracts. Currently, the liability for any failure in delivering the shares is solely borne by the original seller to the ultimate buyer. The onward sellers (in between the original seller and the ultimate buyer) will not bear any of these compensations and charges, and they are allowed to keep the profits that they have received. Therefore, to address the prohibition of profiting without bearing any liability, the paper proposes that in the case of default in delivery, all sellers including the original seller and the subsequent onward sellers shall collectively pay the compensation and charges to the ultimate buyer in proportion to their earned profit.

Second, the paper recommends that further empirical and quantitative studies be carried out in future for the purpose of ascertaining the extent of the public need for contra trading and the real benefits that contra trading brings to the society. These studies would serve as
indicators of whether contra trading deserves a relaxation from the strict Shari‘ah ruling and, on that basis, be considered permissible.

References


Further reading


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The goods and services tax (GST) on takāful products: a critical Sharī‘ah appraisal

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Abstract
Purpose – This paper aims to ascertain the Sharī‘ah (Islamic law) stance on the imposition of goods and services tax (GST) on tabarru‘-based takāful (donation-based Islamic insurance) products in Malaysia. The paper aims to do so by analysing the philosophy, purposes and structure of GST on takāful products and comparing the imposition of GST on tabarru‘-based takāful with its imposition on conventional insurance while probing into the Sharī‘ah texts and opinions of classical and contemporary scholars about taxation in Islam.

Design/methodology/approach – The paper uses a qualitative research methodology. In addition to the literature and text on websites, the information on how GST is applied in practice is also obtained through interviews, discussions and documents from takāful operators. To determine the Sharī‘ah position on GST, reference has been made to classical and contemporary Sharī‘ah literature, including local and international Sharī‘ah advisory bodies’ resolutions and standards.

Findings – This study finds that a strict interpretation of Sharī‘ah does not allow for the imposition of GST; however, there is still room for the government to justify it using a broader interpretation of maslahah (public interest). Takāful has become a need for the society and is subscribed to by all income groups, and not only by the rich. Hence, the government should consider exempting takāful products from GST. The basis of tabarru‘ in takāful does not provide conclusive Sharī‘ah evidence for takāful to be exempted from GST.

Originality/value – This research paves the way for the industry to propose further measures on GST for takāful products such as the exemption of GST on the tabarru‘ amount or imposition of a zero rate of GST on the relevant takāful fees and charges that are currently burdensome to consumers.

Keywords GST, tabarru‘, takāful, Sharī‘ah, insurance

Paper type Research paper

Introduction
The Goods and Services Tax Act of 2014 (GST Act), which has been effective since 1 April 2015, led to the imposition of a tax on takāful (Islamic insurance) products in Malaysia. In line with the tax neutrality approach, takāful is treated equally to
conventional insurance on matters relating to taxation. This has brought about a
debate among stakeholders due to the difference in nature between takāful and
conventional insurance. Takāful represents a tabarru’-based service with mutual risk
being shared among the participants and the takāful operator acting as a manager of
the funds. Conventional insurance, on the other hand, consists of an insurance
premium being paid in exchange for coverage by the insurance company. This
research aims to investigate the Sharī'ah stance on imposing GST on tabarru’-based
takāful products.

Research objectives
The specific objectives of this research are as follows:

- to study the philosophy and purposes of GST;
- to analyze the structure of GST that is applied on takāful products in Malaysia;
- to make a comparison between conventional insurance and takāful in terms of GST
  as well as the tax neutrality concept; and
- to probe into the Sharī'ah texts and the opinions of classical and contemporary
  Sharī'ah scholars on the issues of taxation in Islam, the concept of charity in Islam,
  and the taxation of charitable work and takāful practice.

The general basis of takāful
Takāful provides an alternative to conventional insurance through the application of certain
Islamic principles. These principles, to name a few, include tabarru’ (donation), ta’awun
(mutual cooperation) and wakālah (agency).

The general concept of takāful is based on the principle of mutuality. Rather than the risk
being transferred to one party, a group of takāful participants collectively agree to share the
risk. The participants share the risk by providing tabarru’ to a common pool, with the
takāful operator acting as a fund manager. The collective donation of the takāful
participants in tabarru’-based takāful is thus used to help one another in the case of loss
suffered by one of the participants.

The application of goods and services tax in the takāful industry
The main feature of this newly introduced GST is that all goods and services
provided in the country shall be subject to 6 per cent tax, unless otherwise stated by
the law.

For takāful, family takāful products that provide death or total permanent disability
coverage are exempt from GST. This means that other types of general and family takāful
coverage such as medical, vehicle, personal accident, critical illnesses and financial liabilities
are considered taxable. Besides that, any fees and charges incurred on the supply of services
are also subject to GST.

The GST guidelines do not specify what is taxable, whether it is the whole
contribution (premium) paid by a participant or only the amount that is paid to the risk
fund (tabarru’ amount). For investment-linked takāful products, the practice is to
charge GST only on the tabarru’ amount as the investment and savings are exempt
from GST. However, the takāful industry seems to differ in its practice regarding the
traditional products that are not linked to any investment funds. The reasons cited by
those who charge GST at the contribution level are:
to be more prudent and be on the safe side in terms of abidance by the law;
• to be equal with the practice of conventional insurance; and
• to cut cost by sharing the system with their conventional parents.

Muslim scholars’ views on taxation
Besides zakāh (almsgiving) as a financial obligation on Muslims, Muslim scholars also unanimously allow three types of taxes to be imposed on non-Muslims, namely, jizyāh, kharāj and ḫushr, based on the tradition of the Rightly Guided Caliphs and ijma’ (consensus). jizyāh is a per capita yearly tax historically levied by Islamic states on every non-Muslim residing in Muslim lands. Kharāj is a tax on agricultural land and its produce. ḫushr is a tax on merchandise imported from foreign states that tax the Muslims on their products (Al-Rais, Diya uddīn, 1985, p. 127; Al-Mawsūʿah al-Fiqhiyyah al-Kuwaitiyyah, 2007, vol. 15, pp. 95-97).

Many scholars, especially from the Ḥanafī School, also agree that one-fifth of any minerals, metals, precious stones and jewelleries extracted from the earth is to be paid to the government (Al-Mawsūʿah al-Fiqhiyyah al-Kuwaitiyyah, 2007, vol. 23, p. 100). Some scholars mention consensus that no tax can be levied on any local goods sold domestically unless it is taken and treated as zakāh, which is limited to the rate of 2.5 per cent annually (Ibn Ḥazm, n.d., p. 121; Al-Mawardī, n.d., p. 309; Al-Dardīr, n.d. vol. 2, p. 322; Al-Rais, Diya uddīn, 1985, p. 128).

There is also consensus among classical Muslim scholars to allow the government to collect some of the extra wealth of the rich on a temporary basis in urgent and exceptional cases, such as during war, famine, catastrophe, on the strict condition that the government’s coffers are empty and the available resources are not sufficient to meet the needs of the poor and the needy or the expenditures of the army (al-Juwaynī, 1401H, p. 259; Ibn al-ʿArabī, 2003, vol. 1, p. 88; Al-Qurṭuṣbī, 1964, vol. 2, p. 242; Al-Nawawī, 1991, vol. 2, p. 321; Al-Qaradāghī, n.d.).

The allowance has been broadened by some contemporary scholars, for example, the former grand imam of Azhar University, Mahmūd (2004, p. 109), who allowed the government to levy tax on the people for the purpose of general public interest such as building hospitals, institutions of learning, roads and others. He also allowed taxes to be deducted from people’s money before payment of zakāh. Al-Qaraḍāwī (2000, vol. 2, pp. 297-310) also agrees on the matter of taxation for the public interest with certain conditions. The Malaysian National Fatwa Committee, in its resolution, allowed implementation of GST.

Research findings
The research finds that by applying a strict interpretation of the Sharīʿah, as supported by the consensus reported by Ibn Ḥazm, al-Mawardī and others, GST as a tax on local supplies of goods and services should not be permissible. Moreover, the structure of GST levies the tax on all consumers without differentiating between the rich and the poor. However, there is still room for the government to justify the implementation of GST using a broader interpretation of maṣlaḥah (public interest).

Takāful, as a new financial product, has become a need of the society and it is subscribed to not only by the rich but also by all income groups. Hence, the government should consider exempting takāful products from GST.
Taxation can be benchmarked to zakāh, as they share many similarities in terms of their purpose and objective. Moreover, taxation is allowed by the scholars only when zakāh is not sufficient to support the needs of the people. In takāful practice, as takāful is a form of charity (tabarru’), the tabarru’ fund (risk fund) may be deemed as not being liable to zakāh (AAOIFI, Standard No. 35, 3/1/5 and 5/3/5). Hence, on this ground, the GST should not be levied on the risk fund. However, on the other hand, the charitable (tabarru’) nature of takāful – especially in the Malaysian practice – is not absolute, as the contribution paid by the participants is still considered to be owned by them and the surplus of the fund is also shared among them. On this basis, the fund may be deemed to be liable to zakāh and, hence, GST is justifiable. This is analogous to the case of family waqf (waqf ahlī) where the waqf (endowment) beneficiaries are still liable to pay zakāh (AAOIFI Standard No. 35, 3/1/6). In summation, having the element of tabarru’ does not necessarily eliminate the duty of zakāh or tax.

**Conclusion and recommendations**

The research concludes that Sharī’ah evidence does not support GST and that those who allow it apply a broad interpretation of maṣlaḥah to justify it. However, the research also concludes that having tabarru’ as the basis for takāful is not a strong argument for objections to the imposition of GST on takāful products. However, this research recommends that the government review the imposition of GST on the ground that takāful has become a need of the people, whether rich or poor. The paper also recommends a thorough study be conducted on the contemporary interpretation and application of zakāh on trade merchandise (zakāt ‘uruḍ al-tijārah) as a more Sharī’ah-compliant alternative to GST.

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The effect of IFSA 2013 on late payment of takāful benefits

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Abstract

Purpose – This paper aims to examine the implications of compensation on late payment of takāful benefit imposed in the Islamic Financial Services Act 2013 on the takāful industry in Malaysia. It also aims to identify the issues and challenges faced by takāful operators in the implementation of the compensation and propose solutions for the benefits of the takāful industry.

Design/methodology/approach – This research uses the qualitative approach to understand the practices of claims in takāful and to analyze the implication of compensation on late payment of takāful benefit to the takāful industry in Malaysia. Data are collected through survey and interview with various takāful stakeholders.

Findings – Some of the key findings in this research are that the compensation of late payment of takāful benefit has a positive impact to the takāful industry. The research also found some Shari’ah operational issues in terms of its implementation among takāful operators.

Research limitations/implications – The research focuses on compensation on late payment of takāful benefit claim in death and personal accident only.

Practical implications – The research offers certainty to the takāful industry and an explanation to academic and legal fraternities on the implementation of compensation on late payment of takāful benefit according to Islamic Financial Services Act (IFSA) 2013.

Originality/value – The research provides a valuable contribution to the current practices of takāful operators, identifies some issues and challenges of its implementation and proposes the solution.

Keywords Takāful benefit, claim, late payment, IFSA 2013

Paper type Research paper

Introduction

Buying a life insurance policy is an important financial planning tool that is widely used to protect against financial loss which would result from the premature death of the insured person. Many people die prematurely from illnesses and accidents, with devastating consequences for their families, who are left to pay funeral expenses and outstanding debts and find it difficult to maintain their standard of living. A life insurance policy provides death benefits if the policyholder dies within the tenure; otherwise, it makes available maturity benefits if the policyholder survives the policy term. The life insurance death benefits can only be paid subject to the beneficiary’s submission of a death claim to the insurer.
The literature shows that claim fraud and claim denial have grown to voluminous proportions over the years. These factors have resulted in late payment of insurance benefits, which has proven controversial. Both insurers and policyholders have the obligation to act in good faith after an insurance contract has been formed. With the growing manifestation of claim fraud and claim denial in insurance, all stakeholders in the insurance industry understand the importance of the enactment of law to address these issues. Regarding late payment of insurance benefits in Malaysia, the now superseded Insurance Act 1996 imposed an obligation on insurers to pay interest of four per cent per annum in case a claim made under a life or personal accident policy was not paid within 60 days of its intimation (Insurance Act 1996) (BNM, 1996). The new Financial Services Act (FSA) 2013, which supersedes it, made a change requiring the insurer to pay a minimum compound interest plus one per cent or such other rate as may be specified by Bank Negara Malaysia (BNM) (FSA 2013) (BNM, 2013a, 2013b, 2013c).

The discourse on late payment of insurance claims and the development of the insurance regulatory framework are crucial for the reference of the takaful industry. However, the interest charges as currently practiced in conventional insurance are not compatible with takaful because of the prohibition of ribā (interest) in Islam. The now superseded Takaful Act 1984 did not explicitly address the issue of late payment of takaful benefits, and thus regulatory guidance on late payment of takaful claims was absent in the takaful industry. In line with efforts to streamline the regulatory framework of the insurance and takaful industry in Malaysia, the Islamic Financial Services Act (IFSA) 2013 introduced compensation on late payment of takaful benefits for the takaful industry. This is explicit in Schedule 10, Paragraph 12(1) of IFSA 2013. The introduction of this clause has paved the way for the takaful industry to develop a standard approach in the case of late payment of takaful benefits, which is important for takaful operators and takaful participants alike.

Research objectives
The objectives of this research are to:

- investigate the practices of takaful operators in complying with IFSA 2013 on the issue of compensation on late payment of takaful benefits;
- analyze the views of the regulator and takaful operators on the implications of this Act; and
- propose solutions for the identified issues.

Research methodology
The research adopts a qualitative approach and uses insurance as well as takaful literature and takaful operators’ policies and operational documents to analyze this issue from the takaful perspective. In the effort of understanding this issue from the takaful operator’s perspective, a survey questionnaire has been distributed to takaful operators to seek their views. In addition, semi-structured interviews and meetings with representatives from the regulator, Sharī‘ah authorities, as well as relevant personnel in selected takaful companies in Malaysia have been conducted. This research has been conducted with the collaboration of the Malaysian Takaful Association and takaful operators in Malaysia.
The concept of claim in insurance

The word “claim” literally means demand, assertion and right (Dictionary.com, 2017). In insurance, a claim refers to an application by a policyholder for reimbursement for loss or damage within the terms of an insurance policy (Oxford, 2005). In other words, life insurance benefits are not paid automatically by the insurer to the beneficiary without going through the claim process. Another relevant term which relates to the concept of claim is loss. “Loss” is used to denote the payment that the insurance company makes to the policyholder for the damage covered under the policy.

Settling a claim refers to its fair and prompt payment. It is one of the key objectives of insurance companies. The first step generally required by insurers in settling a claim is notification of the insurer of a death or loss. The insurer will require the claimant to submit a death certificate, claim form and the policy document as evidence. After the claimant submits the required documents, the insurer will investigate and make an assessment based on the documents and facts provided by the claimant. The most crucial part of the claim process is the decision as to whether the claim should be paid, delayed or denied.

Typically, an insurer will take 30-60 days after the date of the claim to review and pay it. Although the time frame for the insurer to settle the claim is not well regulated, insurers in many jurisdictions have had interest charges imposed on them for delay of claim payments. A longer period of delay will result in higher interest charges on the insurer. However, the payment of claims depends on the claimant providing sufficient documentation and accurate information to the insurer. Otherwise, a delay can be as long as several years and might end up with the claim being denied. In some cases, the insurer will take extra time to review the claim and delay the payment because of the contestability clause; for example, whether the insured died within the first two years after the policy was issued or the cause of death was homicide (Investopedia).

The mantra of some insurance companies is that insurance is a business of paying claims. In addition, some insurance companies have used efficient payment of claims as a marketing tool. However, the common perception among people is that insurance companies or their agents are warm and welcoming when they are trying to get business but quickly become cold and unwelcoming when they hear the word “claim” (Rosenfeld, 2014). This perception must be seriously tackled by the insurance industry because claims play an important role in the success or failure of an insurance company. In 2015, the total claim payouts to policyholders of life insurance in Malaysia amounted to RM 9.2bn. They increased by 5.1 per cent in 2016 when total payouts rose to RM 9.7bn (Life Insurance Association of Malaysia, 2016).

IFSA 2013 and compensation on late payment of takāful benefit claims

In 2003, BNM, the central bank of Malaysia, moved to strengthen consumer protection in the insurance industry by introducing guidelines on fair practices (BNM, 2003). Failing to promptly settle claims to a policyholder or beneficiary under one insurance policy to influence settlements under another insurance policy is deemed an unfair insurance practice in the guidelines.

According to the section on claims management in the Takaful Operational Framework issued by BNM on 26 June 2013, takāful operators must ensure that claims processing and payments are done promptly without unnecessary delays and that participants are treated fairly during the process. The growing significance of the takāful industry requires the development of an effective regulatory framework to provide an enabling environment to support its development. The timely introduction of IFSA 2013 addressed this need. Schedule 10, Paragraph 12(1) of IFSA 2013 states:
Where a claim or a part of a claim made under a family *takāfūl* certificate, or under a personal accident *takāfūl* certificate upon the death of a *takāfūl* participant is not paid by a licensed *takāfūl* operator within sixty days of notification of the claim, the licensed *takāfūl* operator shall pay a minimum compensation at the rate of investment yield of the participant’s risk fund, plus one per cent or such other rate as may be specified by the Bank, on the amount of *takāfūl* benefits upon expiry of the sixty days until the date of payment, whereby the one per cent is to be paid from shareholders’ funds.

IFSA 2013 has thus imposed a compensation to be paid by the *takāfūl* operator to the claimant if the *takāfūl* benefits are paid later than 60 days after a claim is made. The compensation comprises two components:

1. an amount at the rate of investment yield of the participant’s risk fund; and
2. one per cent of the *takāfūl* benefits, which is to be paid from the shareholders’ funds.

**Implementation challenges relating to compensation on late payment of *takāfūl* benefits**

Efforts to strengthen the claim practices in *takāfūl* operations are a positive development for the *takāfūl* industry. There are, however, several Shari’ah and operational issues surrounding the implementation of compensation of late payment of *takāfūl* benefits.

The first question relates to the source of the money to be paid as the first portion of the compensation, which is at the rate of the investment yield of the participant’s risk fund. It is not clear whether the money should come from the shareholders’ fund or the participant’s risk fund. IFSA 2013 mentions that “the *takāfūl* operator shall pay”. However, it could be implying that the payment may come from the participant’s risk fund. This is because *takāfūl* benefits are paid mainly from the participant’s risk fund; hence, the claimant should also be entitled to any investment yield generated in the fund.

The second question arises from ambiguity about the rate of the investment yield. The Act does not specify whether it is the monthly rate or the yearly rate.

The third issue is that the *takāfūl* operator is required to pay the compensation regardless of the cause of the delay. The delay in payment could be because of the inefficiency of the *takāfūl* operator or it could arise from the claimant’s act or omission or it could be because of a third party, as shown in Figure 1. In case the delay arises because of the *takāfūl* operator, it can be considered negligent and would therefore deserve to bear the consequences. In another

![Figure 1. The issue of fairness in the source for compensation of late payment of *takāfūl* claim benefits](image-url)
scenario, the delay could be because of the claimant’s non-cooperation in providing the needed documents on time. Alternatively, the delay may occur because of a pending investigation or decision by a third party. In all three scenarios – whether the cause of delay is because of the takaful operator or a third party and/or the claimant – the issue of fairness arises. On the one hand, if the delay is not caused by the takaful operator, then shareholders will still be held liable and burdened with extra costs even though they are not the cause of the late payment. On the other hand, if the delay is really caused by the takaful operator, then the participant’s risk fund may also have to bear the compensation. The question is whether this is fair to the fund and to all the participants. The Shari’ah principles relating to negligence and misconduct, as well as the principle of liability, need to be analyzed in this regard.

The fourth question relates to disclosure. If the investment yield is paid from the participant’s risk fund, does this feature require disclosure to the participants, for instance in the agreement? If such disclosure is made, then it may expose the takaful industry to manipulation and fraud by irresponsible parties, and worse still, this is not within the control of takaful operators.

Conclusion
The introduction of the compensation clause has provided the takaful industry with a standard approach in the case of late payment of takaful benefits, which is beneficial for takaful operators and takaful participants alike. The present study examines the impact on the takaful industry in Malaysia of compensation for late payment of takaful benefit claims. The research concludes that despite the positive response from the takaful industry on the requirement to compensate takaful participants for late payment of takaful benefits, some operational and Shari’ah issues require further deliberation. The research aims to propose solutions and recommendations for the identified issues. The research will offer certainty to the takaful industry and explanation to academic and legal fraternities on the implementation of compensation for late payment of takaful benefits according to IFSA 2013.

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Further reading

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