Critical analysis of some of the major internal hindrance factors in the application of *Musharakah* financing by the Islamic Banks

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Abstract

Despite of the momentous growth of Islamic banking industry in the recent years, the insignificant application of the Profit & Loss sharing (PLS) modes of financing i.e. *Musharakah & Mudarabah* by the Islamic banks has created many doubts at the face of Islamic banking industry. Various studies on the subject highlight different internal and external reasons; however it is still arguable that the lower level adoption of *Musharakah* financing is the result of external factors like adverse selection, moral hazard, customers' lower lever preference towards *Musharakah,* the high risk nature of this mode or is it because of the institution's internal factors like dearth in management's monitoring and controlling techniques in the use of *Musharakah*. Another aspect of the case is that it is the management's risk aversion approach which has limited the use of *Musharakah* based financing. This paper is an attempt to critically analyze some of these important factors that has caused the marginal application of *Musharakah* based financing by the Islamic Banks. It is concluded through logical reasoning that internal factors are far more critical than the external factors.

Key words: *Musharakah, Mudarabah, Shariah,* Monitoring, Controlling

1. Introduction

Islamic finance is based on the principles and mechanisms derived from the provisions of Islamic law. Their characteristics are composed by the exclusion of the interest rate, sharing of profits and losses, risk and uncertainty, asset-backed financing and so on.

Islamic Banking is based on Islamic financial system. It is a banking system whose fundamental rules and regulations are established on *Shariah* laws i.e. Islamic jurisprudence originated from Quran and *Sunnah* of the Prophet Muhammad (PBUH). Its functions must be in compliance with *Shariah* rules and must not violate any *Shariah* principle.

Analyzing the conventional banking system, it is quite evident that the whole system is grounded on deposit creation and lending on the basis of usury or interest. Whereas any kind of business activities based on interest are strictly prohibited in Islamic law and thus cannot be entertained by the Islamic banks at any level of their transactions. Therefore we conclude that Islamic Banking is principally different from modern conventional banking system.

2. Methodology

The methodology used in this conceptual study is a critical analysis of literature survey. The literature on the concepts and studies pertaining to *Musharakah* based financing by Islamic Banks are read to identify factors which motivate or hinder its application in Islamic banking industry. In this paper, the factors are determined through the literature survey of more than 40 articles.

3. Research Objective

The main objective of the paper is the critical review of literature to identify the major internal hindrance factors that influence the application of *Musharakah* financing by Islamic Banks.

4. Growth & Size of Islamic Banking

The significant growth over the past decade and achieving a milestone of USD1 trillion assets the Islamic Banking industry has become as one of the leading financial institutions in the world. The fast growing acceptance of Islamic Finance Industry not only in Muslim majority countries but also in non-Muslim countries is wonderfully encouraging. (S & P Islamic Finance Outlook 2012)

"The World Islamic Banking Competitiveness Report 2012/13" issued by Ernst & Young highlights that the Islamic banking assets with commercial banks globally grew to USD1.3 trillion in 2011, suggesting an average annual growth of 19% over past four years (2011: 24%). The Islamic banking growth story continues to be positive, growing 50% faster than the overall banking sector. Islamic banking assets are forecast to grow beyond the milestone of USD2 trillion by 2014.

Saeed Ahmed – Deputy Governor of State Bank of Pakistan (2014) states in his keynote that, "growing annually by more than 20 percent, the Islamic financial industry asset base has increased to over US$ 1.6 trillion, covering financial centers even beyond Muslim dominated jurisdictions."

5. Major modes of financing by Islamic Banks

Islamic Banks are executing their financial activities under three major groups of *Shar'ah* compliant contracts, i.e. Profit and Loss Sharing (PLS) Base, Trade Base and Lease Base. Under PLS principle two basic contracts i.e. *Musharakah* and *Mudarabah* are applied by the Islamic Financial Institutions for deposit creation and financing/lending activities. Trade Base activities are performed chiefly under *Murabahah*, *Salam* and *Istisna'a* contracts, whereas Lease base financing is adopted under the *Sharia'ah* compliant contract of *Ijarah* in which rent is charged against the usufruct of assets under contract.

Another form of *Ijarah* i.e. *Ijarah muntahia bittamleek/Ijarah wa iqtana* is commonly used method by the Islamic banks in which the ownership of asset is transferred to the customers on the completion of all rental payments, whether at the end of contract or before the completion of contract.

Some of the other services provided by Islamic Banks are based on the *Shariah* compliant contracts of *Wakalah, Kafalah & Jualah*. In these contracts Islamic banks perform business transactions for its customers against predetermined service charges.

6. Significance of *Musharakah* financing

When we go through the classical literature on Islamic Banking, it originates with the core concepts of profit and loss sharing principles. Many of the earlier Islamic economic specialists, scholars and practitioners have undoubtedly identified the importance of PLS mode of financing and its application in the Islamic financial institutions as fundamental for the convergence of conventional *riba-based* system into an Islamic or *Shari'ah* compliant system.

Taqi Usmani, one of the renowned Islamic scholar describes that the Islamic banking literature revolves around the PLS mode of financing since its birth in 1960s. According to him the real and ideal modes of *Shariah*-based financing to be used by Islamic financial institutions should be *Musharakah* and *Mudarabah.*

According to *Udovitch* (1970), the Islamic modes of financing *Mudarabah & Musharakah* were able to mobilize the entire reservoir of monetary resources of the medieval Islamic world for financing agriculture, crafts, manufacturing and long distance trade. They were used not only by Muslims but also by Jews and Christians to the extent that interest bearing loans and other overly usurious practices were not in common use.

Musharakah was commonly practiced in Arabian business life before the advent of Islam. In Islamic history, *Musharakah* remains one of the major modes for investment in business and trade (Anwar, 1987).

Chapra (1992), *Kahf* (1982), *Siddiqi* (1983) and *Zarqa* (1983) all support the idea that profit sharing is more stable than the interest based system resulting in prevention of fluctuations in rates of return.

Ahmad (1994) mentions that all financial resources were mobilized on the basis of either interest or some sort of profit/loss sharing arrangements (*Musharakah* & *Mudarabah*) in the pre-Islamic period. He also mentions that Profit/Loss sharing is the central feature of almost all the Islamic Banking models developed so far. He forcefully argues and believes that the real substitute of usury/interest is the Profit & Loss sharing principles i.e. *Mudarabah* and *Musharakah* along with *qard al-hasanah* while the other techniques like *murabahah, baimuajjal,* *ijarah and ijarah waiqtna* cannot be of equal significance in achieving the Islamic socioeconomic objectives.

Warde (2000) reports that, "in response to criticism of non-partnership-based instruments, many Islamic banks started phasing out the elements of such instruments, particularly *murabahah* contracts, which had been subject to criticism."

Farooq (2006) mentions that, "the movement for Islamic banks and financial institutions originally began with identifying *Mudarabah* and *Musharakah* as the primary modes of operation, arguing that Islam believes in profit-loss-sharing."

Ahmed (2006) gives his views that to give the Islamic banks a complete shape, there is no other alternative but to implement, practice and popularize the *Mudarabah* and *Musharakah* modes of financing.

Highlighting the importance of PLS based financing *Chapra* (2007) emphasizes that the socioeconomic benefits of the prohibition of interest may not be realized fully until the share of PLS modes rises substantially in total financing. It would hence be desirable for the use of PLS modes to gain momentum.

Mirakhor (2007) acknowledges the consensus of Muslim scholars in the issue prohibition of interest and application of profit and loss sharing as the fundamental proposition in Islamic Banking System.

MacMillan (2008) considers that the PLS system is the heart of Islamic financial intermediation.

Shinsuke (2010) clarifies his views that there is a broad consensus that out of all the financial instruments, partnership-based instruments are the most preferable in Islamic economics and finance. This consensus is unanimously supported from the viewpoint of juristic propriety; it is also supported by an economic argument relating to the economic doctrine of Islam, namely that the use of partnership-based instruments is justified by the way any risk involved is properly shared by both parties. He further elaborates that the partnership-based instruments have maintained their position as the first best solution for the Islamic economic system throughout the history of both Islamic economics and Islamic financial practice.

Similarly *Askari* (2012) claims that, "the risk sharing has been an integral part of human activity since long before the formation of modern day corporations, banks, and other financial institutions. It has been a natural activity whereby parties find it profitable to pool resources, be it financial, entrepreneurial, or technical instead of operating individually."

The Islamic banking industry emerged on the basis of two prime motives i.e. avoidance of *Riba* based transactions and to support the overall economic system for creating social economic justice which lies in the core concept of PLS (i.e. *Musharakah/Mudarabah*). But there is a big question mark on the credibility of Islamic banking system due to the non-adherence of these fundamental principles of Islamic financing in their business activities at an acceptable or reasonable level. There are numbers of scholars, practitioners, researchers and the users of Islamic banking who criticize that the Islamic banks have deviated from the right path by not adopting the Profit and Loss sharing principles in major part of their financial activities.

7. Current status of *Musharakah* financing by Islamic Banks

When we analyze the application standing of *Musharakah* financing by the Islamic Banks the situation is not encouraging at all. Applicability of *Musharakah* financing is a still a big question mark on the face of Islamic Banking even after completing the age of about 40 years of commercial practice.

It is quite evident from the following data that the application of *Musharakah* financing remained very low in this business sector all over the world.

S. No.	Region	Percentage Application of *Musharakah* w.r.t other *Shariah* compliant modes of financing
1	Middle-east	8.32%
2	Asia	5.01%
3	Africa	4.19%
4	Europe	0.73%

Source: Islamic Financial Information System (2011)

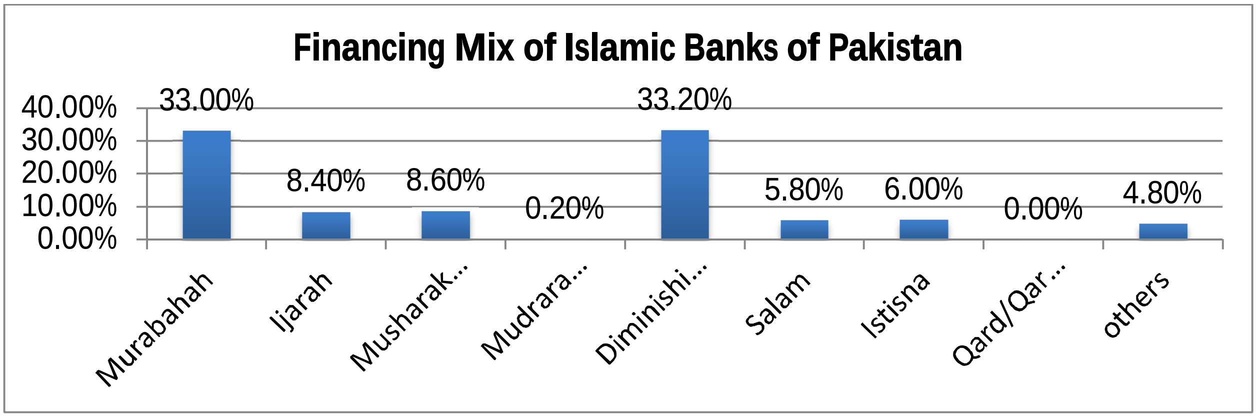
Sudan is considered as one of the financial hubs of Islamic Financing. The Annual Report (2010) issued by the Central Bank of Sudan displays the comparison of different modes of financing between 2009 & 2010:

Mode of Finance	2009 (SDG Millions)	%	2010 (SDG Millions)	%	Change %
Murabahah	8,186.3	55.5%	11,474.1	54.7%	40.2
Musharakah	1,641.4	11.1%	1,981.9	9.4%	20.7
Mudarabah	956.0	6.5%	1,480.0	7.1%	54.8
Salam	349.6	2.4%	257.6	1.2%	(26.3)
Mogawala	1,005.6	6.8%	2,295.5	10.9%	128.3
Ijarah	24.9	0.2%	52.2	0.3%	109.6
Others	2,573.8	17.5%	3,451.5	16.4%	34.1

Source: Central Bank of Sudan

From the above data it is concluded that the application of *Musharakah* increased by 20.7% relating to Capital contribution but as a financing mode it is decreased by 1.7% from 2009 to 2010. On the other hand if we compare this percentage use of PLS modes used by Islamic Banks in Sudan with Islamic Banks working in other parts of the world we can easily conclude that this percentage is much higher than others.

The situation in Pakistan is also not different to others as the statistical data revealed by the State Bank of Pakistan shows discouraging position of *Musharakah* financing by IBs.



Source: State Bank of Pakistan (Jan-March-2014)

Recognizing the significance of participatory financing by Islamic Banks of Pakistan, Kazi *Abdul Muktadir* (2013) rightly mentions, "Given the industry is heading towards more sophisticated and mature level there is a need of a paradigm shift in its prevailing business model. Domestically and globally the Islamic financial industry is focused on trade-based modes and shies away from participatory modes."

8. Major hindrance factors in the application of *Musharakah* financing

Al Haram (1990) attributing the positive example of Sudan Islamic Bank in the application of *Musharakah* indicates that Islamic banks find it difficult to identify sound financing opportunities. Some of the other problems mentioned are the risk of fraud, taxation system, and highly complex nature of equity financing. He also mentioned that the banks find it expensive to employ specialists for financing on *Musharakah* basis.

Khan (1995) points out that several studies have been conducted and results indicate that the dominant factor in the low level of application of *Musharakah* is the *moral hazard.* He also concludes in his study that *PLS* instruments, which can allow profit retention by the user of funds and redeem consequently, could be more popular, particularly among risk-averse start-up firms.

Gafoor (1995) mentions some of the crucial problems associated with the PLS as:

a. Investments under the PLS lock in capital for a long period accompanied with uncertainty and higher risk.
b. Government participation in a project under PLS complicates the process in estimating a return rate on the funds borrowed.
c. Long-term projects offering low returns.
d. Earnings are not immediate with long-term projects.
e. Too many and too frequent changes in the Government policies.
f. Lack of desire in the entrepreneurs to declare profits and share it with the bank.
g. Non availability of proper and timely information from the entrepreneurs.
h. Low ethical stands in the society today.
i. Poor management skills in the entrepreneurs.

The Islamic Research and Training Institute (IRTI) and affiliate of IDB in Jeddah survey report conducted in 1998 indicates that various Islamic banks in different countries had been exposed to some 30 major and minor problems in the application of *Musharakah* financing. Various findings revealed the following common defaults:

1. Moral Hazard
2. Low rate of return
3. Extra expenditure incurred by the Islamic banks in monitoring the partnership projects financed by them under the PLS.

A study on the relative merits and demerits of interest based and PLS (profit/loss sharing) based banking attributes the dominance of interest based banking in the world at large to the problem of existence of the "moral hazard" in PLS based banking even though PLS based banking is superior to interest based banking in several other respects. (*Ahmad*, 1994)

Aggarwal & Yousuf (2000) defend the same viewpoint that the IFIs limit their use of PLS because of the high level of moral hazard.

An imbalance between management and control rights is attributed as a major cause of lack of Profit Loss Sharing (PLS) in the practice of Islamic finance. Given this dichotomy, the agency problem gets accentuated, which may put the PLS at a disadvantage vis-à-vis other modes of financing. However, there is no theoretical reason to believe that PLS is inherently inefficient. (*Dar & Presley*, 2000)

Dar & Presley (2000) also mention that different explanations exist for the lack of PLS financing by Islamic Banks. Amongst these "Agency Problem" is one of them. Other important issue relating to its low level of application is severe competition of conventional banks with Islamic banks. Another area of concern is Islamic banks' reluctance to bear any losses. They also mention that equity financing is not feasible for funding short-term projects due to the ensuing high degree of risk. Unfair treatment in taxation also discourages the use of PLS based financing by the Islamic Banks.

Habib & Khan (2002) clarify after conducting a survey of Islamic Banks managers that the Islamic Financial Institutions prefer mark-up models because of the high risky nature of PLS contracts.

The most influential factor in the marginal application of *Musharakah* model as determined by *Iqbal* & *Llewellyn (2002)* is *asymmetric information*, which is the result of *adverse selection* and *moral hazard* problems. They also point out that the reduction of information asymmetry is a prerequisite for the implementation of an equity-based system.

Another point of view mentioned by *Iqbal & Llewellyn (2002)* regarding the financing of Islamic Banks on the basis of PLS is that the small firms have relatively few assets and being riskier, would prefer the profit-sharing mode of financing to spread their risk. Larger (incorporated) firms have a solid asset base and experience with managing risk. These firms would prefer a fixed mark-up mode of financing (Khan, T., 1995, p. 5). The bank, however, prefers to finance smaller, riskier firms on a relatively risk free fixed mark-up basis and will be comfortable to fund larger, established firms on profit-sharing basis.

Ahmed (2005) articulates that the foremost argument given against the insignificant use of *Musharakah* as major financing mode is "Moral Hazard".

Ahmed (2006) describes three major areas where the Islamic banks find it difficult to finance under the PLS system: (1) Participating in long-term and low-yield projects, (2) Financing the small businesses, and (3) Granting non-participating loans to running businesses.

Chapra (2007) expresses his views that the share of PLS modes is so far relatively small in the financing operations of Islamic banks, and that of sales-based modes is predominantly high. The reason may perhaps be that the task is difficult and in the initial phase of their operations these banks do not wish to get exposed to risks that they cannot manage effectively. They are not properly equipped for this in terms of skilled manpower as well as the needed institutional infrastructure.

According to *Tajul Islam* (2005), financing under the equity participation method is most risky for banks in developing countries due to major reasons such as (a) lack of proper accounting, (b) lack of honesty, integrity, and character of investors (c) insufficient number of skilled entrepreneurs and (d) presence of contrary laws and regulations.

MacMillan et. el. (2008*),* pronounce that the operational difficulties, business ethics, bad projects with high risk & overoptimistic prospective profit figures, lack of special regulatory framework, inefficient procedures & low level of expertise, high monitoring cost, inefficient tax system and high rate of illiteracy are some of formidable obstacles in the practical scope of PLS instruments.

Chong & Liu (2009) mention several possible reasons for the poor adoption of the PLS paradigm in practice, like PLS financing encounters severe principal–agent problems, moral hazard problems associated with ex-post information asymmetry. The adoption of the PLS paradigm is constrained by competition as well as by best practices from conventional banking. Accordingly PLS financing requires more costly monitoring.

Shinsuke (2010) indicates that from the viewpoint of micro-economics, the use of partnership-based instruments in Islamic finance get involved in the incentive problem, which implies that the use of partnership based instruments cannot result in the most efficient solution owing to the asymmetry of information which further leads to adverse selection in the period before a contract is entered into and moral hazards in the period after a contract is entered into.

Chattha & Bacha (2010) consider *credit risk* which arises from the extensive moral hazards inherent in the PLS contracts as one of the major hindrance factors in the implementation of *Musharakah* financing.

Another aspect of low level of application of PLS mode is pointed out by *Nihar* (2011). He identifies that the low content of PLS contracts in the financial statements of the Islamic banks indicate that competition has made the banks to modify their contracts for survival and therefore Islamic banking practices do not deviate substantially from a conventional bank.

Jouaber & Mehri (2011) explain that *moral hazard* and *adverse selection* are the major causes of marginal use of PLS method of financing be Islamic Financial Institutions.

It is also revealed by *Goud* (2012) in his article "Indonesia can serve as a testing ground for PLS bank financing" that profit and loss sharing contracts are inherently more difficult to operate in a banking environment because of *adverse selection* and *moral hazard*.

Ali (2012) also determines that "in case of Islamic banks the moral hazard problem is double edged sword."

The constraints on the development of Profit/Loss sharing methods are believed to be caused not only by the "asymmetric information" that the contract involves but also by the nature of banks as short-term finance institutions. *(Abalkhail & Presley)*

It is further elaborated by *Ismal (2013)* that the Islamic banks prefer debt-based financing to equity-based because of the complicated procedures, the exhausting demands and experience required to be able to engage in long term investment.

According to *Farooq & Ahmed* (2013) lack of interest of the bank management in *Musharakah* financing, Unavailability of Guidelines/Regulations from the Central Bank, Lack of

Interest of the Bank Management, Risk of Loss, Accounting Problems, lack of interest from the customers, lack of committed, honest and skillful entrepreneurs, lack of expertize, lack of government legal support, Unavailability of Checks and Balances Mechanism of *Musharakah* Business, and Taxation Issues are some of the main causes of slow growth of *Musharakah* as a mode of finance in Islamic Banking Industry.

Mentioning the case of Pakistan *Hooker* (2013) explains, "PLS was avoided by the Islamic Banks because of a lack of credibility in the Pakistani government. The financial sector was characterized by little accountability and rampant corruption so IBs were reluctant to use PLS as they would have difficulty monitoring their investments. There was also little demand for PLS from businesses; extensive tax evasion made the business community comfortable with cooking the books on tax returns however PLS demands accurate accounts so that returns on investment can be shared with precision between the two parties. Businesses were reluctant to supply this information to banks and in turn banks were hesitant to believe the quality of the information provided (Akram 1994)."

Summarizing the various hindrance factors influencing the application of *Musharakah* financing by Islamic banks we conclude that these may fall into following three major categories:

A. **Internal Factors;** that are affecting the application of *Musharakah* which include:
    - Management's Monitoring and Controlling Techniques
    - The role of top management
    - Effect of *Shariah* supervision
B. **External Factors;** that are affecting the application of *Musharakah* which include:
    - Customers' Preferences
    - Government Policies
C. **Communal factors** include**:**
    - Moral Hazard
    - High Risk
    - Operational Difficulties

Analyzing the whole scenario of *Musharakah* financing we may conclude that it is still arguable whether the lower level of application of *Musharakah* is because of the external factors revealed by the practitioners of Islamic Banking or is it because of the internal factors relating to the management's risk aversion approach, management's monitoring and controlling technique or the effect of *Shariah* compliance that restrict the application of *Musharakah* based financing by the Islamic Banks.

Critical Analysis of some of the Internal factors influencing the application of *Musharakah* in Islamic Banking sector:

There are many internal factors that may affect the application of *Musharakah* financing by the Islamic banks however if we scrutinize these factors we conclude that all these factors can be summarized into following three major categories that have the most significant effect on the application of *Musharakah* financing. These are:

1. Effect of management's monitoring and controlling technique

Referring to *Fama & Jensen (1983)*, "Control" is the right to ratify the initial proposals and supervise the projects either through internal monitoring or external mechanisms.

The major elements in management of risk are its identification, measurement, monitor and management of different kind of risks. These can be effectively implemented through broader process and system. The risk management of individual financial institution is dependent upon the size of the institution, its nature of business and the sophistication of the institute (*Jorion, 2001*).

Ali (2006&2007) mentions that, "Internal control failures has resulted in collapse of some reputable conventional banks. Noted example includes that of *Barings* which failed in 1995 because a trader in one of its subsidiaries kept on doing fraudulent trade unchecked by higher management and the parent company until accumulation of huge losses when it was discovered."

According to *Malcolm Knight*, The General Manager of the Bank of International Settlements (2007), there are some fundamental principles that are essential for any banking or financial system, among them the need for strong corporate governance, rigorous risk management and sound capital adequacy requirements.

Berle & Means (1968) list five ways to control a corporation: (i) control through almost complete ownership; (ii) majority control; (iii) control through a legal device without majority control; and (v) management control

According to *Radner (1992) Monitoring* and *Controlling* are two very important features of management in any organization. These features play a vital role in the application of *Musharakah* financing by Islamic banks as well. It is stated by number of scholars, researchers and the practitioners that inefficient monitoring and controlling by the Islamic banks' management have greatly affected the application of *Musharakah* financing.

Errico & Farabaksh (1998) express their views that "Prudent supervision of Islamic banks is as important as is the supervision of conventional banks. Operational risks must be managed, and there must be transparency."

Karim & Archer (2007) view that the customer will normally be the managing partner in the venture, but the bank may participate in the management and thus be able to monitor the use of the funds more closely. They elaborate that the operational risks that may be associated with *Musharkah* investments are as follows:

a. The Islamic Bank may not perform adequate due diligence in appraising the venture to be financed and the soundness and reliability of the customer. Lack of appropriate technical expertise can be a cause of failure in a new business activity.
b. During the *Musharakah* investment period, the bank may not carry out adequate monitoring of the financial performance of the venture, and may fail to receive adequate financial information in order to be able to do so.

Iqbal et. el. (2007) express their concern that, "dealing specifically with Islamic banks, Archer, Karim and Al-Deehani (1998) detail the contractual basis of Islamic banks to outline the special need for corporate governance and disclosure by Islamic banks due to the monitoring weaknesses inherent in the Islamic banking system."

In contrast to the above other scholars like *Dar & Presley* (2000) opine differently. They argue that in a typical PLS arrangement, an Islamic bank provides the risk capital to a firm in which professional managers are responsible for making strategic and operational decisions. They mention that, "Participation in management is a natural form of control."

As for the question of Islamic finance serving as an alternative system, *Hassan & Rasem (2009)* opine that "Islamic finance has a built-in risk management mechanism that enables the global financial system to perform in an orderly manner and avoid such crisis".

According to *Ali (2006&2007)* there is a moral hazard problem associated with both *Mudarabah* and *Musharakah* contracts. To keep the problem under tolerable limits the banks have to incur some monitoring costs. During a period of economic growth businesses in general are profit making. Therefore, if a client tries to deceive the bank by reporting losses it can be readily identified and scrutinized. Thus monitoring costs become less than usual during a boom. On the other hand, during a recession when majority of businesses are making losses, if a profit making client cheats the bank by reporting losses it is hard to identify. Thus monitoring costs increase during recession. This counter-cyclical movement in monitoring costs have implications for the profitability of Islamic banks relying on partnership modes (*Musharakah* or *Mudarabah*). If the above argument holds, the profitability of Islamic banks will tend to increase during an economic boom and fall with recession.

Whereas in case of Islamic bank: (i) the bank shares with the depositors the actual outcome of its investments, (ii) monitoring of its clients is a required feature. Thus the conflict of interest between the depositors and the bank is reduced by virtue of the former feature of returns sharing. Further, there is advantage of reduction in monitoring cost in case of financing of own business as compared to financing an outside firm.

A bad performance of only one business which is owned by a bank can cause reputation damage to the bank and knock over effect leading to its financial distress. Since the nature of participatory financing requires Islamic banks to actively participate in the businesses they finance, therefore it is very important for Islamic banks that they expand very carefully into new businesses in which they plan to have majority share. Unless the business is *Shariah* compatible and bank possesses the required monitoring resources, horizontal expansion for the sake of diversification only is a dangerous prospect that can produce contagion affect for the bank.

It is evident from the above scholarly viewpoints of various scholars and researchers that monitoring and controlling are as much important for Islamic Banks as for other conventional financial institutions. Since *Musharakah* inherently provides monitoring and controlling rights in the business ventures therefore this mode of finance is advantageous to Islamic Banking system in monitoring and controlling their financing activities. It provides updated information relating to various market situations and thus can assist the banks to diversify their financing venues for healthy profit orientation. It is the responsibility of top management to make monitoring & controlling more effective in their system of management particularly when financing on *Musharakah* basis.

According to Dar & Presley (2000) there is no serious problem with this (PLS) arrangement if the bank is able, and is allowed, to monitor business operations of the firm. However, proper monitoring mechanisms are yet to be devised for PLS.

2. The role of top management

The role of top management is very critical in the application of *Musharakah* financing by Islamic banks. It is observed and stated by many of the researchers that top managements' risk aversion approach has limited the use of *Musharakah* financing in the Islamic banking sector.

Dar and Presley (2000) opine that the Public confidence in PLS can only be established if ownership and management of Islamic banks show their own commitment to this principle. An important step in this direction will be introduction of profit-related pay for managers and employee share ownership plans (ESOPs). This is expected not only to have a positive effect on the productivity of management and other employees, but will send a healthy signal to the general public indicating commitment of the owners and managers to the principle of PLS.

3. Effect of *Shariah* supervision

Sheikh Delorenzo (2000) stresses upon the need of 'more specialized *Shariah* supervision, or supervision geared toward specific sectors within the Islamic Finance industry instead of a single central *Shariah* Supervisory Board.'

Balz (2008) points out a curious fact which is that in conventional finance the law normally serves to make the transaction enforceable in court, and provides transaction security. In contrast, in Islamic finance, "the role of the *Shariah* is reversed; *Shariah* is a risk, which allows the transaction to be attacked on the basis that it did not conform to Islamic legal principles."

To deal with *Shariah* risk, *Bin-Ibrahim (2009)* points out that the management is responsible for understanding the objectives of *Shariah*; reviewing business processes and activities to ensure full *Shariah* compliance; identifying, assessing, systematically monitoring and controlling *Shariah* risk.

Brown (2009) cites *Mirakhor's* opinion that "the most important lesson of the global crisis for the Islamic sector is that "*it is in urgent need of a uniform system of international regulation, including a single Shariah authority, to remove the threat of potential instability."*

Shariah scholars and Islamic banks should be proactive in order to correct the recent trend which has resulted in the hasty development of some products that "bend certain key precepts of Muslim jurisprudence to breaking point" (*Wigglesworth 2009c*).

Y-Sing (2010) reports that Malaysia's Central Bank (BNM) in its 2009 annual report required Islamic banks to set up *Shariah* review, audit and risk management control functions to reinforce compliance. According to BNM "the framework aims essentially to strengthen the *Shariah* governance process, decision-making, accountability and independence."

Saeed Ahmed (2014) highlights the importance of *Shariah* and states that, "the Effective *Shari'ah* compliance is central to the operations of Islamic banking."

Salahuddin et. el. (2014) consider that loyalty to the rules of *Shari'ah* is the most effective factor in making Islamic banking attractive to customers.

As an alternative to standardization, *Shariah* scholar *Elgari* recommends adopting the scientific methodology in scholars' deliberations "*Shariah* is a science. It requires methodology and resolutions require peer review and market consultation."

Analyzing the above it is concluded that the *Shariah* compliance is recognized as one of the major hindrance factors in the application of *Musharakah* besides other modes of financing however the solution is accessible i.e. by establishing and adopting standardized *Shariah* rules and regulations for IFIs of the entire world. The task is difficult but the tremendous work done, such as AAOIFI and IFSB's guidelines and rulings in this regard are a step ahead towards the solution. Also the encouragement from Central banks of Muslim countries particularly Bank Negara Malaysia Bhd. and State Bank of Pakistan in enhancing the level of *Musharakah* financing and providing solution for *Shariah* related issues to the Islamic banks are inspirational towards the application of *Musharakah* financing at a larger scale.

To our understanding, if managed properly, *Shariah* compliance would act as a deterrent to all sorts of risks involved in the business transactions of Islamic financial institutions instead of being a hindrance factor in the application of *Musharakah*.

Concluding Remarks

The proponent of *Musharakah* financing strongly believe that the only solution to the existing economic & financial crises is the extended use of *Musharakah* by Islamic Banks in their lending activities.

Chapra (2009), argues that one of the major causes of these crises is the absence of risk-sharing, which dilutes market discipline in the financial system and leads to excessive lending, high leverage, speculation, and unsustainable rise in asset prices. He points out that the generally recognized most important cause of almost all crises has been excessive and imprudent lending by banks. There would be a check on excessive lending only if the banks were afraid that this would lead to losses, souring of their reputation, and bankruptcy. This does not happen in a system where profit-and-loss sharing (PLS) does not exist, the repayment of loans with interest is generally assured, and "the too big to fail" concept ensures survival.

Shahrul (2012) concludes that risk management plays an important role in Islamic banks. Islamic banks have a better risk monitoring system followed by internal control and risk mitigation strategies. As several products are depending on the PLS principle so measuring and recognizing every kind of risk is critically essential in Islamic banks.

Zainol & Kassim (2010) recommend two alternatives for the Islamic Banks. Firstly, the IBs should move away from fixed rate instruments like murabahah and BBA into profit and loss sharing contracts like musyarakah and mudharabah. The advantage of the profit and loss sharing contracts is that the financing will be detached from the return rate movements since they are directly independent on profit or loss from the financed business. Secondly, a risk-sharing agreement between Islamic banks and their customers should take into account that the customer of long maturity loans agrees to partially compensate the banks if the average rate of return exceeds the predetermined level. In return, the banks agree to reduce the mark-up on outstanding balance if the rate is below the predetermined level.

According to *Kamarudin & Ismail (2013)*, "Based on profits and losses principle, Islamic participative financial intermediation reduces costs of information as well as transaction and permits risk sharing. They also highlight the fact that participative intermediation leads to an equitable, stable and sustained economic development. It can help to resolve a variety of problems: poverty and unemployment."

Akacem & Gilliam (2002) and *Mehmet* (2007) thinks that profit sharing concept may approach to market solution because it requires direct involvement of civil society, managerial skills and expertise in overseeing different investment projects from the banks. The banks need to have a correct perception in considering the superiority of equity financing compared to debt-like instrument. Therefore, they concluded that the argument that PLS contracts are too risky for Islamic banks to adopt is not convincing. Thus they think further research and discussion is needed in order to provide continued support to the practice of PLS.

From the above discussion we may conclude that following two factors inflict the most significant effect on the lower level of application of *Musharakah* by Islamic banks.

1- Management's monitoring and controlling technique causes effect on the application of *Musharakah* at a greater scale because of the fact that they are not fully equipped to deal with the issues relating to *Musharakah* based financing.

2- The risk aversion approach of top management has also affected the larger reliance on *Musharakah* based financing by the Islamic banks.

We recommend conducting further studies to evaluate these impediments to objectively **evaluate the criticisms on impracticability of *Musharakah*** based financing in Islamic Banking.

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