CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Results

In general, this paper has explored the equity-based project financing under the concept of profit and loss sharing scheme. When interest is prohibited and replaced by profits, the Syariah has developed two specific forms of business arrangement under the profit and loss sharing system, that is Mudharabah (trustee profit sharing) and Musyarakah (joint-venture profit and loss sharing) scheme of project financing.

Mudharabah and Musyarakah financing is least emphasised although Muslim scholars are constantly suggesting that the above principles are the preferable principles and it is considered as the stronger application of Islamic principle. This is line with most of research results as discussed in Chapter Four. The results of the survey indicates that Islamic banking is in favour of debt based financing over equity based financing which is reflected by low growth of less than 2 % in Mudharabah and Musyarakah financing from 1997 to 1999. Due to the relatively small amount of financing under Mudarabah and Musyarakah, it is apparently clear that long term financing activities have been financed by deferred sale instruments such as BBA, Al- Ijarah and Al- Istisnaa.

The islamic banks regard the risk-return (profit and loss sharing) as a very risky investment under the Mudharabah and Musyarakah concept. Therefore the most popular financial instrument in Malaysian Islamic banking system is Al-Bai Bithaman Ajil (BBA

or deferred payment financing), followed by Al-Ijarah wa-iqtina (lease purchase financing) and Al-Ijarah (lease financing) which falls under the fee-based financing.

The simplicity of the deferred sale instruments such as BBA, Al-Istisnaa, Al-Ijarah and Al-Takjiri financing render the banks a viable tool to replace the profit and loss sharing form of financing. The Islamic banks may not longer worry about risk of loss as warranted under Mudharabah and Musyarakah investments. Therefore, the Islamic banks are more in favour of debt or term-financing than equity financing.

Problems associated with the implementation of project financing under the profit and loss sharing principle are as follows:

- Profit sharing transactions require trained banking personnel experienced not only in project evaluations but also in Islamic modes of financial transactions. All these requirements tend to increase transaction costs of the banks.

- Therefore the banks are forced to concentrate their loan portfolios in short-term non-profit sharing transactions such as fee , commission or service charges and prefers not to invest under the profit and loss sharing of financing.

- The concept of profit sharing is open to various interpretations from different schools of Islamic jurisprudence such as Shafii, Maliki, Hanafi and Hanbali. One of the issues identified from the survey is that on the basis of profit and loss sharing. Shafii

and Maliki justified that the shares in profit in on the basis of percentage of capital contribution. In other opinion of Hanafi and Hanbali, it is more justified to share profits among the partners on the basis of their organisational and entrepreneurial services.

- Direct intervention to supervise and strenthen the borrowers financial control under equity participation in the companies invested needs management and business skills on the part of the bankers which the survey indicates that the respondents are not competent in mitigating various types of risk associated in project financing.

- The survey also indicated that it is evident that the legal infrastructure and BAFIA which apparently restricts participating banks to practice mudharabah and musyarakah i.e owning equity shares of participating companies.The Islamic banking divisions are guided under the BAFIA (Banks and Financial Institutions Act, 1989) guidelines.

In view of the above, another serious deficiency is that there is lack of mechanism to scrutinise and validate the operation procedures of the banks from the Syariah point of view. Recently, the Federal Syariah Court in one of its judgements ruled that financing based on mark-up practiced by the banks is not in conformity with the injunction of Islam (Ahmad, 1994). Mark-up financing such as the murabahah and lease financing are similar to the products offered under conventional banking.

Inadequate legal infrastructure to support an Islamic financial system. Any legal cases on default is treated in the civil court as the only court available is the Syariah court

which deals with matrimonial issues. Therefore, the present legal framework is not conducive to Islamic banking.

- Under the profit and loss sharing scheme, as a partner in a business venture the banks requires extensive knowledge and experience with businesses involved. However the respondents of the Islamic banks still view themselves as bankers and not as businessmen to manage their participating companies.

- Islamic banking is considered by the management of commercial banks just as another product and not as an alternative to banking system. Islamic banking division is carried out on a small scale. Both of these forms of banking offer almost similar products under project financing and due to their past experiences, there is a tendency within the bank to finance the project under the conventional method.This has led to the Islamic division facing competition from its conventionsal division for fianancing of projects .

- Muslim scholars first introduced the profit-loss sharing model to banking in the Islamic countries of a homogeneous society and assuming that the society is filled with ethical economic people and feeling of brotherhood.. The issues highlighted by them are primarily focused to the evils of riba (interest) and less attention on the legal implications. However, in Malaysia, which is a heterogenous society and in the time of modern and complex business environment, intentional torts, fraud and business crimes will bring damages to the company and to the participating bank.. The legal

disputes are mainly handled by civil courts and not by Syariah courts which mainly acts as marriage counsellers. The banks had been cheated by some of its customers in the past. Some of them did not declare their profits while others did not possess the skill to participate in business. This is one of the set back for future investment in project financing under profit and loss sharing scheme.

- Public and private customer perception of interest free banking is expensive. This has been proven true by conducting a case study under the conditions of high and low interest rates on the cost of borrowing under the conventional and Islamic banking .

- Furthermore, Bank Negara did not emphasise on financing under Mudharabah and Musyarakah which is considered as the stronger application of Islamic principle. Therefore , term financing involving a fixed-rate term has been substantial and less reliance is placed on project financing under profit and loss sharing scheme.

Since majority of financing falls under the term financing of BBA , Al-Ijarah and Al-Istisnaa which is based on fixed-rate term and not profit and loss sharing scheme, it is similar to conventional mode of financing and classified as weaker application of Islamic principle.

Islamic banking is not reaping the full theoretical benefits. The underlying concept of Islamic banking is increasingly being diluted in the effort to compete with the conventional banking.

In addition to the above findings, the study also found that the cost of borrowing under Islamic banking which is based on fixed rate is more expensive as compared to the cost of borrowing under Conventional banking which is based on floating rate. Furthermore, it was noted that fixed rate charged under Islamic banking is higher than the prevailing Base Lending Rate. The fixed rate lending used by Islamic banking is based on Islamic principles which results in lack of flexibility to revise its lending rate to reflect prevailing market interest rate as opposed to Conventional banking where revisions are made to reflect market interest rate.

5.2 Conclusion

Although the principles of Mudharabah and Musyarakah are strongly recommended by Islamic scholars, hardly any Islamic banks is channelling more than 10 % of its total financing portfolio along the mode of financing. This is also in accordance with the study done by Sudin Haron (1997).

In contrast to profit and loss sharing principle, contemporary practice of Islamic banks in Malaysia prefers the mark-up principles of financing such as Al-Bai Bithaman Ajil, Al-

Murabahah, Al-Ijarah and Al-Ijarah wa-iqtina. This is because of its simplicity as well as the risk aversion of Islamic Banks while still being profitable.

The principle of Mudharabah is recommended for working capital and project financing but in Malaysia, it is only used for financing of working capital requirement. In Malaysia, Mudharabah concept is used for short term financing of 6 months. So far mudharabahs have been managed primarily by full-fledged Islamic bank i.e Bank Islam Malaysia Berhad and zero participation by the Islamic Banking divisions.

The principle of Musyarakah is only recommended for project financing but it is only used for working capital financing. As per Mudharabah concept of financing, Musyarakah concept of financing is also managed by the same full-fledged Islamic Bank. There is no participation of Islamic Banking Divisions of project financing under Musyarakah.

5.3 Recommendations

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Since Islamic banking's objective is to share in the risk-return of the business venture, the banks would emphasise on selecting projects with good management team with proven track record. Good projects which might be turned down by conventional banks for lack of collateral would

be financed by Islamic banks on a profit and loss sharing basis. The Islamic banks can finance a few small to medium projects rather than financing one mega-size project. The probability of one mega-size project failing is definitely higher than financing a few small projects in various sector. This is referred to as diversifying the banks portfolio risks.

In view of the above, there is a need for specialised Islamic financial institutions such as Mudharabah and Musyarakah equity-based banks as compared to the existing Islamic banks in Malaysia which are trading- based banks. If the setting-up of a special bank is going to be costly, than the present 'Islamic windows' should be segregated into equity-based project financing and trading-based debt financing.

5.4 Suggestions for Additional Research

The results of the study presents some directions for future research. Since the establishment of Bank Islam Malaysia Berhad in 1983, a wide array of research has been done on it's performance, objectives, marketing and its social obligations under the principle of Islamic banking.

Bank Muamalat which was established on October , 1998 as the second full-fledged Islamic Bank after Bank Islam Malaysia Berhad can be evaluated on it's mission, objectives and strategies to be implemented. A keen researcher can study whether Bank Muamalat will be concentrating on project financing based on profit and loss sharing as

to reflect the strong application of Islamic principle or is it going to be concentrating on fixed rate term such as BBA financing and others.

Additional research can be carried out by identifying the market niche of Islamic banking products from the client's perspective.