Remittances Review
June 2024,
Volume: 9, No: 3, pp.766-779
ISSN: 2059-6588(Print) | ISSN 2059-6596(Online)
Received: 28 May 2024, Accepted: 15 June 2024
DOI: https://doi.org/10.5281/zenodo.13294639

Mapping the Knowledge Landscape of Profit and Loss Sharing in Islamic Finance

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ABSTRACT

The two-tier Modaraba theory encourages Islamic banks to deal with participatory modes of financing at both the liabilities and asset levels, allowing for a fair and equitable wealth distribution. The proponents of the theory take it to the extent that they term other modes of financing, such as Murabaha or Ijara to be abominable or less preferable. According to them, these other modes of financing do not promote the same level of equality and fairness and lead to social injustice and inflation and hence are against the Maqasid al-Sharia. On the other hand, practitioners focus on maximizing profit while adhering to Islamic principles and legal requirements with lesser heads to social justice or risk sharing. This gap between theory and practice had been observed contentiously, leading to criticisms of Islamic finance. This study presents the potential determinants of these opposite poles of ideology and discusses the antecedents. It has been suggested that the application of this theory should be promulgated in the wide perspectives of religio-cultural norms that shape the acceptance of risk sharing within a society otherwise the Islamic banking industry may face the issue of financial stability.

Keywords: PLS, Two tier Modaraba, Sustainability, Risk, Bank stability

Introduction:

Islam is a religion that provides a complete financial structure known as the Islamic financial system. It is a financial system that operates according to Islamic law, or Sharia (Dusuki, 2012). Maqasid al-Sharia is a base that provides a theoretical framework for understanding the central values and objectives of Islamic law, or Sharia. It has significant implications for Islamic finance, which is founded on Islamic principles and values. Maqasid al-Sharia emphasizes the importance of achieving social justice based on Islamic values by providing affordable and accessible financial services to marginalized communities (Bouheraoua, 2011). It also promotes

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ethical investment practices that align with Islamic values. This includes investing in socially responsible projects that yield good returns (Elasrag, 2010).

Islamic finance, backed by Maqasid al-Sharia, prohibits the charging of interest ("Riba") and also prohibits investment in industries that are considered haram or forbidden in Islam. Against an interest-based system, Islamic finance works on the central principle of profit and loss sharing (PLS) between the providers of capital and the entrepreneurs involved in the project or investment. PLS based investment ensures that not only the profit but also the losses are shared by investor and investee to protect both parties involved according to the principles of Sharia (Marwene et al., 2023).

On the contrary, Islamic banks, which are followed by Islamic finance, focus on profit maximization and dealing with financial products that are less risky and increase the profit margin. Islamic banks are not following the true spirit of Islamic theory, which emphasizes equality and social justice in financial transactions to safeguard the interests of investors and investees. This gap between Islamic theory and practice is facing criticism, as Mansoori (2011) argued that Islamic finance is based on profit maximization rather than focusing on the principles of Maqasid al-Shariah and has no interest to achieve the objectives of equality and fair distribution of wealth in society. Critics of Islamic finance practitioners believe that the only motive of Islamic banking system is maximization of profit in the name of Islam.

The different financing modes adopted by Islamic banks or institutions are not more than legitimizing the interest by inducting various tricky solutions to the issues and using the Islamic law to achieve legitimate end. It is perceived that different financing modes introduced by Islamic banks are according to Shariah with respect to their procedure and contract only and they ignore the real spirit of Shariah (Mansoori, 2011). By using Shariah, Islamic finance offers only different interpretations of permissible financial contracts (El-Najar & Mohammed, 2014).

This creates a divergence between the theory of Islamic finance and the way it is practiced (Abduh & Omar, 2017). This type of divergence in the financial system can cause issues with stability. Therefore, the objective of this study is to address the gap and propose some homogeneity between Islamic finance theory and its practical implications in the financial market.

Disparity in Islamic Finance

Islamic finance works under the instructions of Sharia and Islamic law. Maqasid al-Sharia provides a framework for the implications of Islamic law, or Sharia, in the Islamic financial system. Maqasid al-Sharia ensures social justice and equality in the financial stream by incorporating financial products that depict the true spirit of Islam. On the contrary, Islamic banks emphasize profit maximization rather than following the concept of social justice and equality governed by Maqasid al-Sharia. Islamic banks follow Shariah to the extent of contractual binding, whereas its implications through financial products are contrary to the depth of Islamic theory. This creates a disparity between Islamic finance theory and its practical implications in the financial market.

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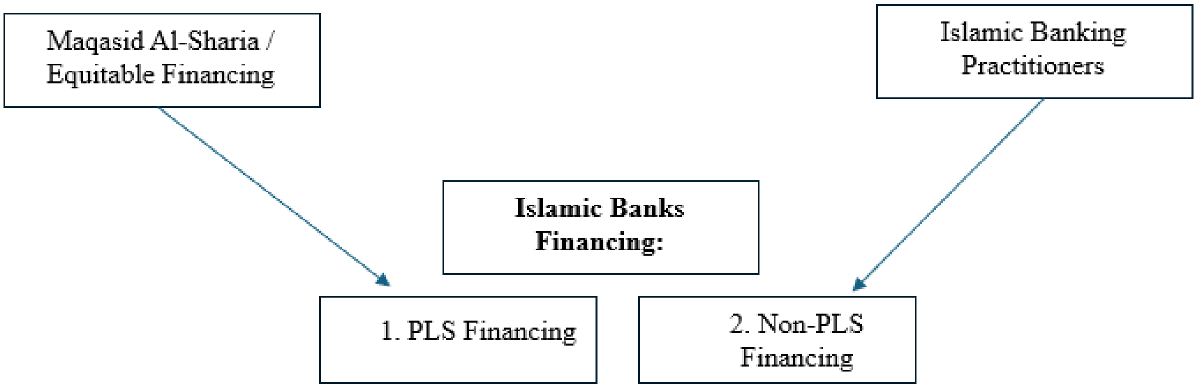

Figure: 1 Reflecting the preferences of Maqasid Al-Sharia and banking practitioners in Islamic bank financing.

Relationship Between Islamic Culture and Risk Management

The concept of risk has always been an integral part of finance, and banking is no exception. Islamic banking, much like conventional banking, is also exposed to a variety of risks in the market due to the different products offered. The risk-taking in the banking institutes may be explained by the resources they hold on the touchstones of the rational theory of finance. While for the bounded rationality approach, the perception of risk is subjective and depends on individual behaviors and cultural beliefs. This study purport that risk-taking in the Islamic banking industry can be a function of the religious culture of the respective society.

Religious affiliation is known to have significant effects on individuals' behavior, including their tendency towards risk-taking in financial investments, commonly referred to as risk tolerance. Previous literature indicated that investors with distinct levels of risk-tolerance may exhibit varying investment decision-making patterns (Pfeifer, 2017). Furthermore, past literature suggested that insurance companies located in religiously protestant wealthy areas tend to avoid engaging in risky investments compared to those affiliated with Catholicism. Such firms also demonstrate lower volatility of earnings and return on assets (Berry-Stölzle, 2021). Research conducted by Nainggolan (2022) examined the influence of board characteristics on the risk-taking behavior and performance of Islamic banks in Indonesia and Malaysia. The study found that Sharia Supervisory Boards (SSB) and Boards of Commissioners (BoC) significantly affect both risk-taking and financial performance in these institutions. It was observed that SSB members with educational backgrounds in both Islamic studies and finance/economics tend to reduce risk-taking behaviors. Additionally, BoC members with an Islamic education background are associated with lower levels of insolvency risk, funding risk, credit risk, and Sharia non-compliance risk. Furthermore, members of both the SSB and BoC with expertise in finance or economics were found to enhance the performance of Islamic banks. Interestingly, older members of these boards also contributed to improved performance. In contrast, it was found that ethical conduct and better stakeholder relationships, inherent within religious organizations, may result in lesser financial

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distress due to low-risk involvement at a firm level. This observation received empirical validation from US-based firm data, by (Heubeck, 2024).

Interestingly, a study found that in Indonesia, Muslim businesspeople with lower levels of religiosity were more attracted to higher-risk Islamic banking products. This finding was accompanied by the discovery of a U-shaped relationship between religious commitment and risk tolerance for these individuals. The direction and intensity of this relationship appears to vary depending on religiosity levels (Aldehayan & Tamvada, 2022). Previous research has also suggested that people who are more devout, regardless of whether they are Christians or Muslims, tend to be less willing to take financial risks. Given the significance of risk tolerance as an indicator of investment behavior, changes in religious or cultural norms can alter risk tolerance leading to subsequent shifts in investment choices (Pfeifer, 2017; Tahir & Brimble, 2011).

Similarly, the religious culture of society at general level can also impact the risk-taking behavior of the individuals. Bakhouche, Ghak, and Alshiab (2021) investigated that whether Islamic institutions are more stable in countries where Islamicity dominates the environment than in countries where Islamicity is less prevalent. Results indicated that Islamicity has a neutral effect on bank stability and that Islamic banks do not perceive a more Islamic environment as a factor in their resilience.

Hutapea and Kasri (2010) confirmed that there exists a long-running relationship between the Islamic banks' profit margin and its determinants. Study suggested that the margin behavior changes as the basis of bank operations changes from conventional to Islamic principles. It exhibits that Islamic banks and conventional banks are different, based on their environmental, cultural, and operational activities. These differences can lead to change in profit margins as Islamic finance supports profit and loss sharing PLS and conventional banks rely on interest-based transactions. PLS based banks are more exposed to risk as it is characterized for sharing loss between investor and investee whereas conventional banks are attributed to gain only profits.

Risk-taking in the Islamic banking industry can be a function of the religious culture of the society. Investors with diverse levels of risk tolerance may exhibit varying investment decision-making patterns. Additionally, ethical conduct and better stakeholder relationships inherent within religious organizations may result in lesser financial distress due to low-risk involvement at a firm level. Further, people who are more devout tend to be less willing to take financial risks. Changes in religious or cultural norms can alter risk tolerance, leading to shifts in investment choices. Moreover, it is assumed that Islamic banks are more stable in countries with more Islamic culture than in countries with less Islamicity.

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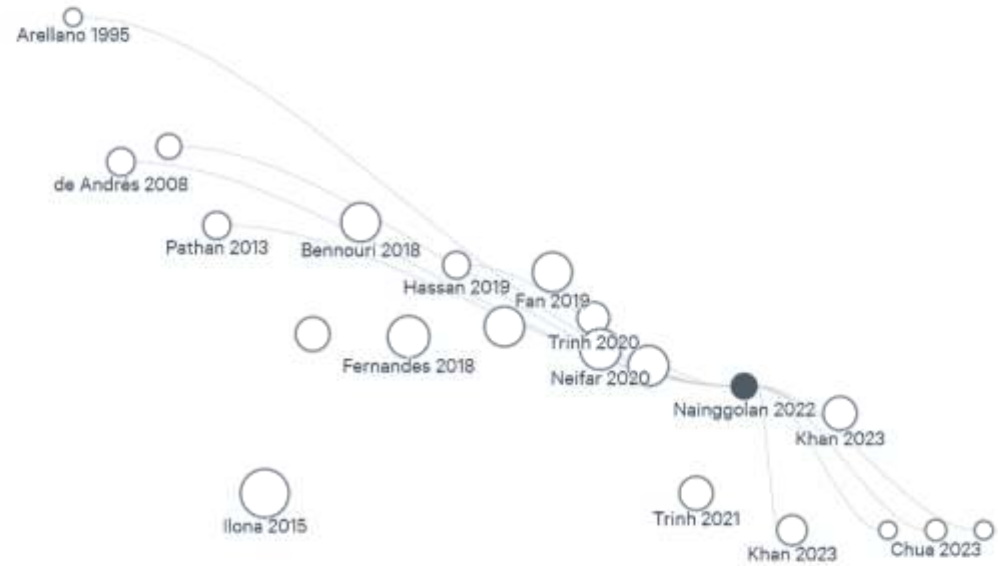

Figure 2: Presents a citation network visualizing the interconnectedness of research on religion and risk management in Islamic finance. Nodes represent studies, while edges indicate citation relationships, revealing influential works and research clusters within the field.

Relationship between Islamic Culture and Participatory Finance

Islamic finance is a type of financial system that operates under the principles and values of Islamic law, also known as Sharia. One of the distinguishing features of Islamic finance is its emphasis on profit and loss sharing financing. Under a profit and loss sharing contract or participatory financing agreement, the profits and losses are shared between two parties, the investor and investee (Bidabad & Allahyarifard, 2019).

In Islamic finance these transactions are termed as Modaraba or Musharka (Dinc, 2019). These transactions are collectively classified as profit and loss sharing instruments (PLS). In these transactions the bank acts as a financier and shares profits or losses with the client. This concept of profit and loss sharing is rooted in Islamic principles, which aim to promote social justice and reduce economic inequality. Islamic finance operates under the framework of shariah law, which prohibits earning interest and requires transactions to be based on ethical values (Sudarsono, 2021). Islamic finance is attributed with profit and loss sharing (PLS) whereas conventional finance deal with interest-based transactions. Out of these two-financing method, the relationship between Islamicity and profit and loss sharing might be significant as Islam and PLS both values equity, risk-sharing, and business partnerships in contrast with interest-based financing. Islamic finance seeks to promote social justice and reduce economic inequality by sharing profits and losses between two parties.

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Hassan, et al. (2024) by utilizing the Partial Least Square Structural Equation Modeling (PLS-SEM) approach, found that the Islamicity of the product has a significant effect on the adoption of Islamic banking. In contrast, perceived behavioral control demonstrates comparatively lower predictive power regarding the adoption of Islamic banking. Yaya et al., (2021) identified key components of PLS financing, including customer empowerment, Shariah compliance, financing duration, installment timing, contract costs, profit-sharing basis, and risk management. The study revealed that PLS financing is typically offered for short durations and is not available for new businesses. It also found that newer Islamic financial institutions are less reliant on PLS compared to their older counterparts. Additionally, the study highlighted that government regulations on PLS are stricter in terms of provisioning and rescheduling. However, there is criticism that participatory modes of financing are not as widely utilized in Islamic finance institutions as they should be (Lewis, 2019). Studies have shown that the growth of Islamic finance banking is supported by the Islamic resurgence rather than inclusion of profit and loss sharing mode of financing. Ibrahim et al., (2021) by taking charity as a proxy of religiosity found no effect of religiosity on profit and loss sharing finance. Further, it was found by increasing growth of charity that people do their religious activities obediently but people in seeing the role of religion in finance is moderate. However, in interaction with Islamic banks, people are still profit-oriented, as indicated by the low average profit and loss sharing financing growth compared to total credit.

Islamicity is composed of factors including religious financial literacy. To endorse this argument, Ali et al., (2021) investigated the influence of Islamic financial literacy, subjective norms, risk perception, and perceived behavioral control on the adoption of Islamic banking. A quantitative research methodology was employed in this study, and the results disclosed that behavioral, normative, and Islamic financial literacy are significant determinants of adoption of Islamic banking. It was determined that behavioral beliefs are crucial to Islamic banking and the implementation of PLS. In Pakistan, the adoption of Islamic banking will increase as a result of a focus on risk management and the provision of high-quality information regarding Islamic banking products to consumers.

Islamic finance is a type of financial system that operates under Sharia law, which prohibits earning interest and requires transactions to be based on ethical values. It emphasizes participatory finance, which is rooted in Islamic principles and aims to promote social justice and reduce economic inequality. Islamic finance provides the operational base for Islamic banking, and the growth of this banking system is only driven by the Islamic resurgence, including participatory modes of finance, behavioral, normative, and Islamic financial literacy. However, focusing on providing quality information and risk management may lead to an increase in the adoption of Islamic banking.

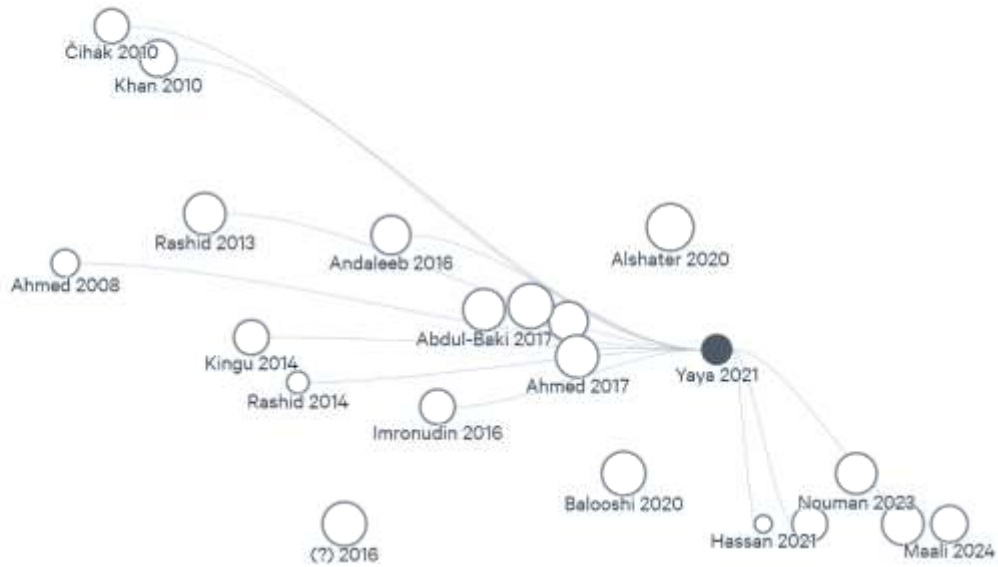

Figure 3: Presents a citation network visualizing the interconnectedness of research on religion and participatory finance in Islamic finance. Nodes represent studies, while edges indicate citation relationships, revealing influential works and research clusters within the field.

Relationship between participation finance and risk management:

The business model of Islamic banks differs significantly from that of conventional banks Beck et al., (2013). PLS distinguishes the Islamic finance activities in financial terms. Brahim et al., (2017) observed that the profit-sharing part of system affects Islamic bank risk differently, the inclusion of interest in banking system is volatile and riskier. Islamic banks use a profit and loss sharing system to distribute profits as well as loss, whereas conventional banks charge interest in their financial system. As the costs of interest-based banking system is fixed and independent of their profit margins, their exposure to risk is greater than that of Islamic banks. Dusuki (2007) shared the same opinion, stating that on theoretically grounds Islamic banks are less exposed to risk if their balance sheet structure is dominated by the participatory finance on both the assets and liabilities sides.

Furthermore, Islamic bank risk management confronts numerous challenges. Managing short-term liquidity fluctuations is challenging for Islamic banks (Al-Muharrami & Hardy, 2013). Salah and Khoutem, (2022) conducted research by considering 23 Islamic banks of GCC countries from 2005 to 2016 to find the determinants of Islamic bank liquidity. The results through GMM estimator showed that restricted and unrestricted profit-sharing investment accounts (PSIA) are inversely proportional to liquidity. Both restricted and unrestricted (PSIA) accounts are a constraint on the liquidity of an Islamic banking system. It was further revealed that deposits financed projects with extended durations and differential mismatch reduces the liquidity of Islamic banks and increase their exposure to liquidity risk. Moreover, PLS investments play no role in the risk management of Islamic institutions in GCC nations.

In addition, Jedidia and Hamza, (2020) concluded that PLS intermediation increases exposure to liquidity risk because Islamic banks frequently use short-term deposits to finance long-term Musharaka and Modaraba. However, for the risk transformation, the participatory finance mechanism between depositors and Islamic banks on the one hand and business owners and Islamic banks on the other, allows less exposure to liquidity risk management. Participatory modes of financing appear to less money creation and to generate a limited liquidity function. Further it was found that the impact of participatory modes of financing on liquidity risk is influenced by the level of Islamic money market development and the existence of Islamic lender at last resort.

Islamic finance through its banking channels is different from their conventional banking counterparts in their business model, as they adopt a profit-sharing system instead of an interest-based system. Management of risk in Islamic banks is difficult due to the lack of high-quality Sharia-compliant liquid assets. Moreover, profit-sharing investment accounts are inversely proportional to liquidity, making them a constraint on Islamic bank risk management.

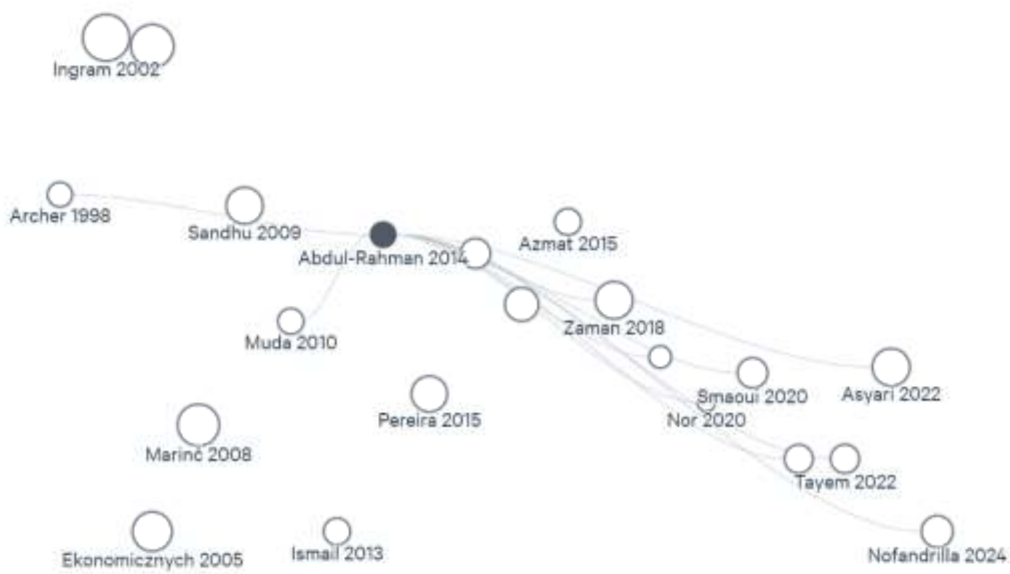

Figure 4: Presents a citation network visualizing the interconnectedness of research on participatory finance and risk management in Islamic finance. Nodes represent studies, while edges indicate citation relationships, revealing influential works and research clusters within the field.

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Conclusion:

Islamic finance follows Maqasid al-Shariah, which incorporates equality and social justice in society. To abide by the Shariah, Islamic finance is against interest (Riba) and requires investment on the basis of PLS. Profit and loss sharing ensures the concept of equality and social justice, in which not only the profit but also the losses are shared between the two parties involved in an investment contract. Conversely, Islamic banking practitioners do not exclusively focus on PLS-based financing; rather, they focus on taking less risk and increasing profit margins. By ignoring the true spirit of Maqasid al-Shariah theory, practitioners are providing financial products that are in their favor in terms of risk and profit margin. They consider financial transactions such as PLS based investments riskier, but the impact of PLS on risk management is still debatable and needs to be assessed through thorough research. On the other hand, PLS type investments provide religious inclusion in the financial market. Religious intervention in society through the financial market is a notable concern. These interventions are acceptable to society if they match their needs and fulfil their financial demands, rather than considering only religious points. Financial institutions need to provide conventional finance as well as Islamic finance so that users of the financial market may have a choice. Enforcing any specific type of finance may lead to distress and instability in the financial market, which can lead to economic pressure.

Directions for future research:

Based on the insights and findings presented in the conclusion, several key areas for future research can be identified to further explore and enhance the understanding of Islamic banking, particularly focusing on PLS mechanisms and their impact on default risk, economic development, and financial stability.

Future research should investigate the development and implementation of robust operational and supervisory frameworks for PLS financing. This includes exploring best practices for risk management, monitoring, and regulation to ensure the effective and sustainable application of PLS instruments in Islamic banking (Bidabad & Allahyarifard, 2019). Future research can analyze this scenario of depositor-protection under different supervisory and regulatory regimes. It can yield a differential note that how different regimes on PLS financing impacts bank stability. Studies can also focus on case studies from different Islamic financial institutions that have successfully implemented PLS mechanisms, highlighting their strategies, challenges, and solutions. Comparative research between PLS and non-PLS financing models in Islamic banks can provide deeper insights into their respective impacts on default risk, profitability, and financial stability. Such studies should consider various economic contexts, market conditions, and regulatory environments. Evaluating the long-term performance and sustainability of PLS versus non-PLS financing can inform policymakers and practitioners on the optimal balance between these financing models.

Investigating the influence of socio-cultural factors on the adoption and success of PLS financing is crucial. Research can examine how different religious cultural attitudes towards risk-sharing and Islamic principles affect the willingness of businesses and individuals to engage in PLS arrangements. Cross-country studies can compare the adoption rates and success of PLS financing in regions with varying degrees of adherence to Islamic socio-cultural norms. Maqasid al-Shariah

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and the Sustainable Development Goals (SDGs) initiated by the United Nations share a common objective: the attainment of a sustainable human life (Harahap et al., 2023). Future research should explore the relationship between participatory finance and the SDGs, with a particular focus on addressing hunger and poverty in various regimes.

Islamic banking, particularly PLS financing, can directly impact credit and liquidity risks (Farihana & Saifur Rahman, 2020). The effect of financing on the credit or liquidity risk of a single bank can influence the entire Islamic banking sector, potentially affecting the broader money market. Future research should explore the development and functioning of Islamic money markets, which are essential for managing liquidity risk in Islamic banking. This includes studying the role of Islamic lenders of last resort and the effectiveness of liquidity management tools in Islamic financial systems. Analyzing the integration of Islamic money markets with global financial markets can provide insights into potential challenges and opportunities for Islamic banking. Examining the role of technological innovations, such as blockchain and fintech, in enhancing the efficiency, transparency, and security of PLS financing. Research can investigate how these technologies can address operational challenges and improve the scalability of PLS models.

Studies can explore the role of international regulatory bodies and standard-setting organizations in promoting best practices and harmonizing regulations for Islamic finance. Investigating the role of PLS financing in supporting entrepreneurship and SME development (Tayem, 2022) . Research can focus on the specific needs and challenges faced by SMEs in accessing PLS finance and propose solutions to improve access to finance for small and medium-sized enterprises. Evaluating the impact of PLS financing on business growth, job creation, and economic development in various sectors and regions.

Exploring the behavioral aspects of stakeholders in Islamic banking, including depositors, investors, and borrowers. Understanding their perceptions, motivations, and decision-making processes can provide valuable insights into the adoption and effectiveness of PLS financing. Surveys and interviews with stakeholders can reveal the psychological and cultural factors influencing their engagement with Islamic banking products (Mohammad Dulal Miah & Yasushi Suzuki, 2022). By addressing these areas, future research can contribute to a deeper understanding of the complexities and opportunities in Islamic banking, particularly regarding PLS financing. These insights can help policymakers, regulators, and practitioners to develop more effective strategies and frameworks to enhance the growth, stability, and socio-economic impact of Islamic finance.

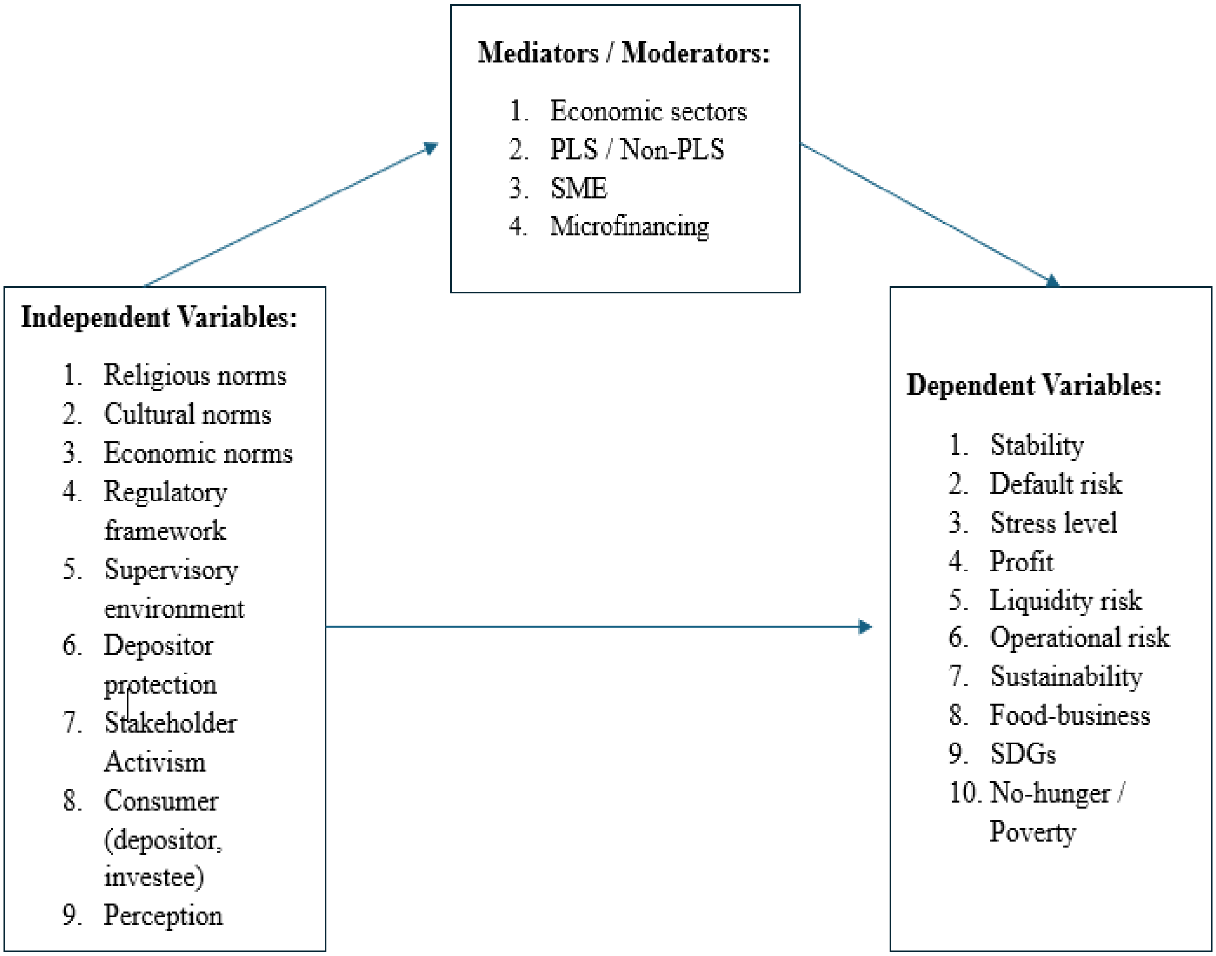

Figure 5: Presenting the directions for future research and introducing potential independent, dependent, mediating, and moderating variables.

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