

## **Finance and Growth: The Role of Islamic Contracts**

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## **Abstract**

Although, Islamic law has been in existence for more than fourteen hundred years, but its implementation have been subjected to the willingness of the rulers in the passage of history and civilization. Although, the study on financial contracts has been extensively reviewed, the role of Islamic contracts is not highlighted, except those in the historical institutional and contract theory literatures. The study that link finance and growth takes many dimensions. One of the dimensions is law and finance view. In the beginning, the studies that link the former only look at the finance variables and economic variables. Further development analyses the relationship at the system level, i.e. discussion whether bank-based vs. market-based matters on growth. Islamic finance comes up with its distinctive contracts and products of profit-loss sharing. It may give different character and notion in the financial system in particular and in the economic system in general. This paper is aimed at discussing Islamic laws which are relevant to finance. Most importantly the aspect of contracts as foundation for the distinctive Islamic financial products, i.e. the one resembling profit-loss sharing nature containing cooperative spirit, will be analysed to establish a strong connection with financial stability as pre-requisite to achieve the economic growth.

***JEL Classification:*** G2; K2; K4;

***Keyword:*** Islamic law; finance; profit-loss sharing.

## 1. Introduction

Law and finance, as argued is a set of contracts. These contracts are defined – and made more or less effective – by legal rights and enforcement mechanisms. From this perspective, a well-functioning legal system facilitates the operation of both markets and intermediaries. The operation would overall affect the level and quality of financial services – which finally improve the efficient allocation of resources and economic growth.

This has motivated Levine et al. (2000) and Beck and Levine (2002) to examine the different legal and accounting standards among country and their effects to financial intermediaries' development.<sup>3</sup> By categorizing countries into four legal families; French, English, German and Scandinavian (descended from Roman law), Levine et al. (2000) use the differences in the legal origin that cover the legal rules on secured creditors, the efficiency of contract enforcement and the quality of the accounting standards and find that the financial intermediaries' developments are connected to the legal and regulatory characteristics defining intermediary's activities.

Then, Beck and Levine (2002) do some experiments on the judicial efficiency by assessing the efficiency and integrity of the legal environment, produced by the country-risk rating agency Business International Corporation. The rating is average over 1980-83 and ranges from one to ten, with higher numbers indicating higher level of judicial efficiency. The correlations indicate that judicial efficiency is positively correlated with finance-aggregate and structure-aggregate<sup>4</sup> and negatively correlated with state ownership. The finding indicates that countries with more efficient legal systems experience higher level of financial development and are more market based system but are less state ownership bank.<sup>5</sup>

Although, Islamic law has been in existence for more than fourteen hundred years, but its implementation have been subjected to the willingness of the rulers in the passage of history and civilization. Although, the study on financial contracts has been extensively reviewed, the role of Islamic contracts is not highlighted, except those in the historical institutional and contract theory literatures. For instance, a few of them such as paper done by Gonzales de-Lara (2001) which discusses risk-sharing in financial contracts with focus on the sea-loan (debt-based) contract and *commenda* (equity-based or *mudharaba*) contract. Whereas *The Mejelle Ahkame Adliye*<sup>6</sup> was elaborated between 1869 and 1876 as a part of the Legislative purpose of the *Tanzimat*, initiated in imperial Turkey, with the approval of Sultan (Rahman, S.A, 1967), has been in the market since the late of nineteenth century but not implemented due to colonial era which forced the colonized countries to follow their laws, e.g. common law in Malaysia and Dutch law in Indonesia.

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<sup>3</sup> The intermediaries development were measured on the followings: Restrict (regulations restricting banks from engaging in securities market activities, insurance, real estate transactions and owning non-financial firm), State Ownership, Finance-aggregate, Judiciary efficiency and Industry elasticity. See, Beck and Levine (2002) pp. 162-163 for the result of the analysis.

<sup>4</sup> Finance aggregate is the first principal component of finance-activity [log (total value on the private sector as share of GDP)]: focuses on government ownership of banks and structure aggregate provides a measure of the comparative role of banks and markets in the economy.

<sup>5</sup> As shown by La Porta et al. (1998) which examines legal rules covering protection of corporate shareholders and creditors, the origin of these rules and the quality of their enforcement. The result shows that common-law countries generally have the strongest, French civil-law countries is the weakest, legal protections of investors, and German and Scandinavian located in the middle.

<sup>6</sup> The Penal Code of 1850 and the Commercial Code of 1861 were the predecessors of the *Mejelle* but these two compilations had been largely based on the laws of European countries. The *Mejelle* represents an attempt to codify that part of *Hanafi fiqh* which treats of *muamalat* (transactions between people). The codification was the work of a Commission of Jurists, headed by Ahmad Djevdet Pasha, the Minister of Justice (Rahman, S.A, 1967).

Since, Islamic teachings covers all dimensions of human life includes guiding the relations among people as individual and as a communal in various aspects such as economic, social, cultural and political. Accordingly Muslim individual cannot compartmentalise his/her behaviour into religious and secular dimensions as he/she is always asked to be bound by *shari'a*. Islamic law thus embodies an encompassing set of duties and practices including worship, prayer, manners and morals, marriage, inheritance, crime and commercial transactions: that is, it embraces many aspects that would not necessarily be considered as law elsewhere (Lewis and Alagoud, 2001: 16). Based on this fact therefore Islamic teachings on transactions may have a strong distinctive character in the economy provided that they are implemented properly taken into account all necessary spirit, rules, regulations, and institutions.

The fact that under Islamic law on transactions there are various types of contracts, from contract of sales and purchases, contract of usufructs such as leasing, contract of sharecropping, partnerships and equity participation, and Islamic banking establishments, emerged significantly in the last three decades, are permitted to adopt all these contract types, then it is logical to classify Islamic banks into a universal banking institutions.

The objective of this paper is to discuss Islamic laws which are relevant to finance. Most importantly the aspect of contracts as foundation for the distinctive Islamic financial products, i.e. the one resembling profit-loss sharing nature which contains cooperative spirit, will be analysed to establish a strong connection with financial stability as pre-requisite to achieve the economic growth. It is believed in this paper that embarking from cooperative spirit, through developing equity partnership instruments in the financial system, will be able to create a more sound value added in the economy, so that higher economic growth and more equitable distribution of resources can be achieved simultaneously.

The remaining discussion of this paper will be divided into 4 sections. Section 2 contains prior studies in the area of finance and growth. Section 3 exposes Islamic law covering origin and financial contracts. Further discussion on legal right and protection under Islamic finance is contained in Section 4 which includes right and protection, mechanism of corporate governance, *Shari'a* Advisory Council.

## **2. Prior Studies**

The study that link finance and growth takes many dimensions. One of the dimensions is law and finance view. In the beginning, the studies that link the former only look at the finance variables and economic variables. It can be seen from the following studies. King and Levine (1993a, 1993b) use cross-country regressions to show that the level of intermediation at the start of the period is positively related to the rate of economic growth during the period. King and Levine's work is part of a rapidly developing literature on intermediation and growth which includes Saint-Paul (1992), Pagano (1993), Cetorelli (1997), Levine and Zervos (1998), Rajan and Zingales (1998), and Cetorelli and Gambera (1999), among others.

Later researchers have expanded further to look at the role of balance sheet of both banks and firms. Both are known as bank's balance sheet view and firm's balance sheet view, respectively. From the former view, authors like Kashyap and Stein (1995) and Bernanke and Gertler (1995), propose that, under tightened monetary policy, banks adjust their stock of loans by reducing the maturity of loan originations and reallocate short-term loan supply from small firms to large firms. This reallocation is known as 'flight to quality'. They show that bank lending channel works through changes in loan maturity and balance sheet channel works through reallocation of short-term loan supply. We interpret this as evidence

supporting existence of a bank lending channel since one of the links in the chain of causality behind the bank lending channel is that after a monetary contraction, bank lend less.

However, the firm's balance sheet view is against the bank's balance sheet view. They argue, as originally proposed by Robinson (1952) that "where firm leads finance follows" is frequently quoted. In other words, as quoted by Koetter and Wedow (2006), financial services are provided as a reaction to the demand by corporate firms, that is finance follows entrepreneurial activity. The statement is explicit in claiming that financial development takes place endogeneously in meeting the demand of expanding real economy. Support for Robinson's view could be found in the works of Friedman and Schwartz (1963) and more recently in the works of Claessens, S. and Laeven, L. (2003).

Furthermore, Bernanke and Gertler (1989, 1995) provide an argument on the connection between the firm's balance sheet and business cycle, which is partly due to the movement of capital stock component.<sup>7</sup> They predict an accelerator effect of financial fragility on investment, for instance a negative shock to productivity today decreases the current income of the entrepreneur, then it causes future agency costs to increase and hence future investment and production depress. Empirical evidences on the relevance of firm's balance sheet, as reported in Kiyotaki and Moore (1997), indicates that investment is sensitive to financial factors. This especially so, during a downturn, where in this respect Bernanke and Gertler (1989) argue that the proportion of credit advanced to the borrowing firms with low agency costs increases. This phenomena is known as flight to quality

Therefore, both views come up two propositions, i.e., "finance leads investment" and "firm leads finance". However, the former proposition leads us to expand our view to the role of capital market. The role can be seen clearly in Beck et.al, (2000a). They argue that, less-dependent bank, due to, for instance, expensive cost to extract firm information might cause firms to face higher charge from bank and hence might reduce firms' incentive to take more profitable projects (with higher risk level). The proponent of this view also indicates the weaknesses of bank's balance sheet view in that banking system might impede innovation and growth. Therefore, the proponent of firm's balance sheet view is aimed at: reducing inefficiencies connected with bank's balance sheet view and facilitating new firms creation and hence the investment to grow.

More important than that whether the legal system could provide good enforcement and protection to investors. Hence, the impact will be on the greater financial development. The following studies would give the answer.

Gonzales de-Lara (2000?) advances that in Late-medieval Venice institutional arrangements that enhanced the State's ability to verify information expanded the set of contracts that the Venetian State could enforce and enabled the transition from the *sea loan* (a debt-like contract) to the *commenda* (an equity-like contract). This implied a better allocation of risk and, arguably, further mobilization of capital. The paper also shows that the *sea loan* and the *commenda* contracts sustained the optimal allocation of risk given their underlying institutional foundations. Moreover, the enhanced State's ability to verify information supported the first-best allocation of risk, which was attained by letting the merchant finance part of the venture and raising additional funds through *commenda* contracts. Thus, the paper provides a rationale for the efficiency and observed co-existence of debt and equity, as well as for the participation of merchants-entrepreneurs to the funding of their own ventures (inside equity).

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) find that countries with legal environments characterized by "good" investor protection laws have larger and broader capital markets, and thus firms in these countries have more access to external finance. For

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<sup>7</sup> Florio (2006) provides a good survey on this connection.

example, they calculate that the ratio of stock market capitalization (adjusted for insider ownership) to GNP is 60 percent for English common law countries versus only 21 percent for French civil law countries. Our research is related to theirs because the legal systems in the transitional economies have been identified as a significant barrier to the development of more advanced systems of financial intermediation.

Along the same lines, Durnev and Kim (2005) use firm-level data from 27 countries to identify corporate governance and disclosure practices. They find that firms with better investment opportunities, concentrated ownership, and greater need for external financing practice, better governance, and that these firms are consequently valued higher. These attributes are stronger in countries with weaker legal systems. Klapper and Love (2003) find similar results in their study of firm-level corporate governance practices across emerging market countries. The authors find that better corporate governance is associated with higher operating performance, with higher *Tobin's-Q*, and with higher valuations. They also find that firm-level corporate governance provisions matter more in countries with weak legal environments. Analyzing the determinants of effective legal institutions and their impact on economic development, Berkowitz, Pistor, and Richard (2003) analyze the “transplant effect” (the impact of legal systems transplanted from other, more advanced countries) for 49 countries. The authors find that while the transplant effect has no direct impact on economic development, it has a strong, indirect effect via legality (e.g. enforcement). They suggest that the strong path dependence between economic development, legality, and the transplant effect explains why legal assistance that is primarily focused on improving law on the books has little impact on economic development.

However, Rajan and Zingales (2003) argue that factors such as legal origin or culture do not provide a complete explanation for cross-country differences in financial development. In fact, they document a reversal in financial markets from 1913 to 1980 which is inconsistent with pure structural theories of financial development. They suggest an “interest group” theory where incumbents are opposed to financial development because it allows competition. Thus, political forces that are favorable (or unfavorable) to financial development are major factors in determining the development of the banking system. They contend that while many developing countries need institutions, including financial institutions, it may simply be that special interests in the countries are not allowing these institutions to develop. The issue of the development of a viable system of intermediation in the transitional economies raises interesting policy issues. For example, Meltzer (1999) argues that because Russia lacks the rule of law, private property, and a solvent banking system, IMF loans to Russia to promote piecemeal reforms are a waste of money. Furthermore, he points out that financial crises in Indonesia, Korea, Thailand, Malaysia, and Russia all occurred in part because these countries lack a sound banking system.

Cook (1997a, 1997b) reports a low level of intermediation and small business lending in Russia, a conclusion which is consistent with previous research.<sup>8</sup> Similar results have been reported for Poland (Feakins, 1997), the Czech Republic (Mladek, 1997), Hungary (Vajda, 1997), and in general for the 29 transitional economies by Murrell (1996). Most of these studies report that the primary source of working capital for small firms is retained earnings and that inadequate finance is a major constraint on growth. Calvo and Coricelli (1993) suggest that the output collapse in Eastern Europe during the transition resulted, at least in part, from a credit crunch affecting aggregate supply. The problem is partly a legacy of the former centrally planned economies where, as Calvo and Coricelli (1993) report, banks had no incentive to collect firm-specific information about borrowers. A history of government

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<sup>8</sup> See Cook (1997b), p. 1, 8–9. Boyco, Shleifer, and Vishny (1993) report that, for all practical purposes, Russian companies have no access to external finance and sell at about 100 times less than Western companies with comparable assets. See also La Porta et al. (1997), p. 1131.

bailouts also creates moral hazard problems by removing the incentive to develop lending standards (Hansson, 1995). Many studies also report the lack of an effective system of bank supervision and regulation in these countries as an obstacle to the development of intermediation (e.g. Hansson, 1995; Rostowski, 1995). A special issue of the *Journal of Banking and Finance* (Hermes & Lensink, 2000) provides an extensive discussion of financial system development in the transitional economies, and Buch (1996) also discusses this issue in detail, but neither provides a comparative analysis of the level of intermediation in the 29 transitional economies. Murrell (1996) and Rapaczynski (1996) also call attention to low levels of banking activity and legal development in the transitional economies, but do not provide comparative intermediation data.

This happens to the former Soviet countries, as reported in McNulty, Harper and Pennathur (2007), where they relatively exhibit lower levels of financial intermediation than developing countries, and is consistent with findings of previous studies.

### **3. Islamic Law: Origin and Financial Contracts**

The discussion in Section 2 shows that law plays an important role in developing the finance field. However, the role of Islamic law seems to be left out in the current mainstream discussion in finance. Therefore, the aim of this section is to discuss the basic idea on the differences of law origin, and financial contracts in Islam that may affect the design of financial institutions.

#### **3.1. Origin of Islamic Law**

The Muslim scholars have unanimously agreed that, when examining any new subject or incident that has no rule or legal value, the provisions of the primary bases of Islamic Law must be referred to. These are the Quran and the *Sunnah* that includes the Prophet Muhammad's (peace be upon him) words, deeds and tacit approvals. In a case where there is no equivalent rule provided by these two non-arguable sources, usually Islamic scholars will subsequently resort to the secondary or dependent sources of law, the *Ijma'* (general public consensus), the *Qiyas* (reasoning by analogy), the *Maslahah mursalah* or *Istislah* (reasoning by public interest), the *Istihsan* (preference), the *'Urf* (customs or common practice) and *Sadd al-dhara'i* (blocking the means).<sup>9</sup> Thus, when a jurist wants to know the status or legal rule of certain issue or problem, he must refer to the primary sources first, according to the order of the sources. Unless he could not find the legal rule or the right solution to the issue concerned, he may then refer to the secondary sources, whichever relevant.

#### **3.2. Financial Contracts**

A contract (*'aqd*) is referred to an obligation which arises from a bilateral relationship between two parties. In this context, contract is defined as "the conjunction of an offer emanating from one of the two contracting parties with the acceptance of the other in the manner that affects the subject matter of the contract".<sup>10</sup> Therefore, a contract is the result of a mutual agreement between the parties irrespective of who initiated the offer and who accepted it.

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<sup>9</sup> There are a few other secondary sources that scholars rarely resort to, they are, *Shar'c man qablana* (the divine rules of other Prophets) and *Madhhab al-sahabi* (words and deeds of the companions of the Prophet).

<sup>10</sup> Refer to the Mejjelle (Art. 103), translated by Tyser, C.R., D.G. Demetriades and Ismail Haqqi Effendi. Kuala Lumpur: The Other Press

In addition, for a valid contract to take place in *Shari'a*, certain conditions are to be met. The majority scholars hold that there are three elements of a valid contract namely the form (*sighah*) which comprises of offer (*ijab*) and acceptance (*qabul*); the contracting parties (*al-'aqidayn*) and the subject matter (*al-ma'qud 'alayh*) i.e. the commodities and the considerations (example: deposits).

The Muslim scholars consider that a contract is completely concluded if there is concurrence of offer and acceptance representing the wish of the parties to enter into a contract. Since a contract is a bilateral agreement, thus there must be more than one party who are negotiating for the contract, and they must be qualified persons possessing the legal capacity (*ahliyyah*). In addition to that, the subject matter of the contract must be defined properly that leave no ambiguity to the contracting parties as to the nature of the subject matter. Another important requirement to form a contract is the purpose of the contract. As such, the contract must be for good and beneficial purpose according to the *Shari'a*. Consequently, the subject matter of the contract must also be legally acceptable in the eyes of *Shari'a*.

There are two general financial instruments that could be applied in finance, i.e., investment and means of payment. **Investment** in the form of *mudharaba* is considered as a special form of partnership (*Musharakah*) that has been deployed by modern Islamic financial institutions to provide fund management services. In line with the Islamic principles of risk-sharing and profit-sharing, it is characterized by one party (*rabb al-mal*) entrusting his money to another party (*mudharib*) who is akin to a fund manager and who contributes to the arrangement by providing the necessary experience and management expertise. The *mudharib* will utilize the money in an agreed manner, and will subsequently return the principal and a share of the profit to the *rabb al-mal*, retaining a pre-agreed share of the profit for him.

Some papers observe that the *mudharaba* contract, along with *musharaka* contract which reflects profit-loss sharing characteristic, has a very strong merit in the sense that it relies on the spirit of cooperation. Presley, and Sessions, (1994) have shown that the use of the prevalent alternative method of financier remuneration (i.e. *mudharaba*) will, under certain conditions, lead to an enhanced level of capital investment on account of the ability of *mudharaba* to act as an efficient revelation device. By applying the ideas developed in the Western contract literature by Holmstrom and Weiss (1985) and Meyer (1986) they show that a *mudharaba* contract between a project manager and a syndicate of investors may permit a more efficient revelation of any informational advantage the manager may have over the latter. Nienhaus (1988) emphasizes that theoretically, Islamic banks, through PLS financing, should provide capital to dynamic entrepreneurs who have good projects but cannot offer collateral, and so create new business and thus contribute to the community's economic development.

The important principles to note are: the division of profits must be on a pre-agreed proportional basis; if a loss occurs then the *rabb al-mal* will not usually face liability beyond the loss of principal; and the *mudharib's* liability will generally be confined to the loss of his time and effort only.

*Mudharaba* may be entered into for a single investment or on a continuing basis with the Islamic banks acting as a fiduciary. *Mudharaba* investments may be made for fixed terms and arranged through negotiable instruments (called investment deposit certificates or *Mudharaba* certificates) and in such situations may have characteristics akin to shares.

The uses of financial instruments as **mean of payment** can be seen from the following definition. For example, Islamic banks act as agent (or *wakeel*) and hence receive fee payment. The common meaning of the word "payment" is "the action, or an act, of paying; the remuneration of a person with money or its equivalent; the giving of money, etc. The



word is also defined as "a sum of money (or other thing) paid; pay, wages; or price". The verb "to pay," from which the noun "payment" is derived, is variously defined as "to give what is due, as for goods received; remunerate; recompense; to give or return as for goods, or services; to give or offer." However, "to pay" have also been construed as meaning "to give money or other equivalent value for; to hand over the price of a (thing); to bear the cost of; to be sufficient to buy or defray the cost of". Thus, although the word payment often connoted an exchange of value for the provision of goods or services, or the provision of value on the occasion of a particular event or condition, it could also encompass bearing the cost. This latter meaning is perhaps the most consistent with the word's use in the context of a provision defining non-performing financings.

#### **4. Legal Right and Protection under Islamic Finance**

From the discussion in Section 2 and 3 shows that laws varies across countries, in part because of differences in legal origin. Hence, how does Islamic law provide legal right to the contracting parties? Or, in specific, does Islamic law provides both *mudharib* and *rabbul-maal* protection? Do the countries (that adopt Islamic law) have other substitute, mechanism of corporate governance? Because, the differences in legal protections of contracting parties might help explain why firms are financed and owned so differently in different countries. Why do firms practically have no excess to external finance? Why is the ownership of firms so widely dispersed (by contract)? The content of legal rules in different countries may shed light on these corporate governance puzzles.

##### **4.1. Right and Protection**

The effect of contract can be seen in the rights, obligations and legal effects. These effects are not one and the same in all contracts, but they vary from one to another. For example, the effects of the contract of sale are the transfer of proprietary rights in things, obligation of the seller to deliver goods and establishment of his right to demand the price. The effects of rent are the transfer of proprietary rights in usufruct to the tenant. Thus, we find that these effects differ from one contract to another.

It can be said in general that the following effects accrue from the contracts. *First*, the owner has the obligations to perform the transfer of proprietary rights in things or usufruct, commutative or non-commutative, such as sale, gift, rent, and borrowing.

*Second*, obligation of performing a specified work regardless whether this work is the delivery of fungible property which is a debt which a person owes to another, such as contract of loan, or it is some other work, such as the work of a hiring or agent.

*Third*, arising the right of security as, for example, in pledge, surety and bail, and transfer of debt.

The general rule is that the above effects accrue only from the contract which fulfils the conditions of its constitution and validity, and with which no attribute which requires the Lawgiver's prohibition against it is associated. But some jurists maintain that some of these effects sometimes accrue from a void contract, and it is one with which an attribute required by the Lawgiver's prohibition is associated.

The general principle is that these effects arise and accrue from a contract after its existence. But there are some contracts whose effects keep away from them till permission is attached to them: According to the Muslim jurists, they are called the suspended contracts or contracts in abeyance.

When these effects accrue from the contract, the general rule is that they are binding on both contracting parties. Neither of them can dissociate itself from it. But there are some contracts whose effect accrues from it when both parties grant the unilateral right of cancellation, or one of them does so without the consent of the other party. These are called permissible contracts, or contracts that are not binding.

These effects accrue from the contract by making and taking it into consideration by the Lawgiver and the intention of the contracting parties has nothing to do with it. A contract, in the opinion of the Muslim jurists, is a cause of accrual of effects from it. The general rule is that accrual of effects from causes is on account of making, and act of the lawgiver; the intention of the contracting parties has nothing to do with that.

Accordingly, the jurists maintain that every condition which is attached to the contract and deviates from its effects is invalid. They call this condition repugnant or contrary to the essence or nature of the contract. But the conditions that are consistent with the essence or nature of the contract and confirm the effects which accrue from it are permitted according to all jurists, because they strengthen these effects and confirm their execution such as the stipulation of pledge and surety.

There is another set of conditions about which disagreement arose. These are the conditions which neither agree nor disagree with the essence or nature of contract, and set restrictions on the freedom of the contracting parties, regardless whether or not they comprise the benefits of the stipulating party.

The established rule in the *Shari'a* is the obligation of fulfilment of contracts and conditions which do not make an unlawful thing lawful and a lawful thing unlawful. Allah, the Exalted, said: "O you, who believe, fulfil the obligations". (5:1) The Prophet (peace be upon him) said: "The believers are bound by their conditions, except a condition which makes an unlawful thing lawful and a lawful thing unlawful". This shows that the contract is the law of the contracting parties as maintained by modern law.

The application of this rule requires that the contracting parties are bound to execute the obligations that accrue from the contract without having the right of modifying it or dissociating from it, except in cases about which specific texts of the *Shari'a* have occurred. If one of the contracting parties does not execute the obligations which the contract imposes on him of his own accord, the other party can compel him to execute them judicially, as the Lawgiver grants this contracting party the right of abstaining from executing the equivalent or opposite obligation or to demand the annulment of the whole contract.

The general rule in Islamic law is, as is the case of positive law that these contracts are not binding on any other than their contracting parties and no one other than the parties can benefit from them. The fulfilment of obligations that result from the contract is not binding on any person other than the parties to it, as no one except them can benefit from the rights established by the contract.

We shall see that there are some cases, in each of the Islamic law and positive law, in which the effects of the contract are traceable to the persons other than the contracting parties. These contracts are called general or particular discrepancy in positive law. These cases are considered to be an exception to the general rule of relativity of contracts with respect to persons.

As for *mudharaba* contract, the contracting parties are the capital provider (*shahib-al-maal*) and the entrepreneur (*mudharib*). The principal obligation of the capital provider is to provide the capital needed by the entrepreneur, whereas the obligation of entrepreneur mainly to manage the capital in his/her business venture/project in a responsible and trustworthily manner so that the business he/she managed capable of creating value added (profit) that will be shared according to the pre-agreed ratio. The capital provider right mainly is to get the profit share or to born the financial loss without having any control in the management of the

business/project. Based on this nature *mudharaba* financing usually be called as trusty financing.

In current development of Islamic banking practices, *mudharaba* contract is widely applied in both sides of intermediary function of Islamic banks, i.e. funding and financing sides. In funding side, *mudharaba* deposits, either in saving account or mainly in investment/time deposit account are the major component of bank's deposits. Even though this is quite similar with those in conventional banking system, profit-sharing nature of Islamic bank's deposit has important advantage to the financial system compared to their conventional counterpart.<sup>11</sup> At this juncture we can compare the depositors and the shareholders in the Islamic banking system<sup>12</sup>. Both are similar in providing financial capital to the banks, even much higher proportion for depositors, but the rights of both capital-givers are quite different. Table 1 below exhibits a comparison between depositors and shareholders in Islamic banking.

**Table 1: Depositors and Shareholders Comparison in the Islamic Banking System**

	<b>Depositors</b>	<b>Shareholders</b>
Contracts	<i>Mudharaba</i>	<i>Musharaka</i>
Contribution	Financial capital as investment deposits	Financial capital as shared capital
Rights: Rewards	Return on Deposits based on Pre-agreed Profit Share	Dividends
Voting	No Voting Right	Voting Rights
Control	No specific control right	Control rights via Shareholders General Meeting
Obligation	No obligation bounded	Oblige to add capital if deem necessary
Risk	Exposed to all business risk	Exposed to all business risk
Protection	Under Deposits Insurance Scheme only. <u>Need to have a kind of specific protection by providing access to the management</u>	Shareholder protection under the prevailing laws

<sup>11</sup> In term of stability of financial system, profit-sharing deposits are much better scheme to build a more sound and healthy financial system. See further discussion in Khan and Mirakhor (1987)

<sup>12</sup> See Tohirin (2004)

The existence of *mudharaba* deposits, along with *mudharaba* and *musharaka* financings, under Islamic banking system exposes very different character from that in interest-based deposits. This difference actually has important implication into the financial system, in the sense that it drives the system to be more stable due to a balance between asset and liability sides of the system. In addition, *mudharaba* deposits in fact may be treated as “equity capital” similar to shareholders funds. Based on these reasoning, it is therefore important to consider specific institutional protection mechanism for *mudharaba* depositors, especially if the system allows Islamic banks to co-exist side by side with conventional banks.

As for *mudharaba* financing from the banks’ viewpoint it is also important to provide specific enforceable regulation mechanism as a truth revealing devices for the financed parties to avoid any miss-reporting of their business ventures. In this regard Gonzales de-Lara (2001) recorded the experience of the Late Medieval Venice that the existence of state enforcer of contract had been effectively used for risk-sharing contract by Venetian merchants. It had driven the shift of contractual agreement from the *sea-loan* contracts (which is debt-based) to the *commenda* contracts (which is profit-loss-sharing based). Applying this spirit into current practices of Islamic banking and finance might drive the implementation of profit-loss sharing financing more significantly.

#### **4.2. Mechanism of Corporate Governance**

There are several interesting features in Islamic finance such as equity participation; and risk and profit-loss sharing arrangements. On the one side, an Islamic bank is essentially a partner with its depositors, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment. The depositors also share in the profits according to predetermined ratio, and are rewarded with profit returns for assuming risk.

These financial arrangements imply quite different stockholder relationships, and by corollary governance structures, from the conventional model since depositors have a direct financial stake in the bank's investment and equity participations. As discussed above, the Islamic bank is subject to an additional layer of governance since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of the Muslim community. For this purpose, Islamic banks form the *Shari'a* Advisory Council.

Therefore, the governance structures are quite different because the Islamic banking institution must obey a different set of rules - those of the *Holy Qur'an* - and meet the expectations of Muslim community by providing Islamically-acceptable financing modes. There are two major differences from the conventional framework. First, and foremost, an Islamic banking organization must serve God. It must develop a distinctive corporate culture, the main purpose of which is to create a collective morality and spirituality which, when combined with the production of goods and services, sustains the growth and advancement of the Islamic way of life.

Second, Islamic banks are based on the Islamic legal concepts of *shirka* (partnership) and *mudharaba* (profit-sharing). An Islamic bank is conceived as financial intermediary mobilizing savings from the public on a *mudharaba* basis and advancing capital to entrepreneurs on the same basis.

The profit-and-loss sharing arrangement operates under the following rules:

- The Islamic bank receives funds from the public on the basis of unrestricted *mudharaba*. There are no restrictions imposed on the Islamic bank concerning the kind of activity, duration, and location of the enterprise, but the funds cannot be applied to

activities which are forbidden by Islam. In this regard it is necessary to provide some kind of protection to the depositors, which provides similar financial capital to the bank as the shareholders but in much higher proportion, beyond the deposit insurance mechanism because the profit-loss sharing nature of the deposits provide risk-absorbing mechanism by balancing the asset side with the liability side to create a more stable banking system.

- The Islamic bank has the right to aggregate and pool the profit from different investments, and share the net profit (after deducting administrative costs, capital depreciation and Islamic tax) with depositors according to a specified formula. In the event of losses, the depositors lose a proportional share or the entire amount of their funds. The return to the financier has to be strictly maintained as a share of profits.
- The Islamic bank applies the restricted form of *mudharaba* when funds are provided to entrepreneurs. The Islamic bank has the right to determine the kind of activities, the duration, and location of the projects and monitor the investments. However, these restrictions may not be formulated in a way which harms the performance of the entrepreneur, and the Islamic bank cannot interfere with the management of the investment. Loan covenants and other such constraints usual in conventional commercial bank lending are allowed.
- The Islamic bank cannot require any guarantee such as security and collateral from the entrepreneur in order to insure its capital against the possibility of an eventual loss. This very fact implies that a different mechanism need to be reconstructed to provide a smooth mechanism of risk mitigation, such as enforcement mechanism to guarantee transparency to prevail that any miss-reporting of activities can be avoided.
- The liability of the financier is limited to the capital provided. On the other hand, the liability of the entrepreneur is also restricted, but in this case solely to labor and effort employed. Nevertheless, if negligence or mismanagement can be proven, the entrepreneur may be liable for the financial loss and be obliged to remunerate financier accordingly.
- The entrepreneur shares the profit with Islamic bank according to previously agreed division. Until the investment yields a profit, the Islamic bank is able to pay a salary to the entrepreneur based on the ruling market salary.

Many of the same restrictions apply to *musharaka* financing, except that in this instance the losses are borne proportionately to the capital amounts contributed. Thus under these two Islamic modes of financing, the project is managed by the client and not by the Islamic bank, even though the Islamic bank shares the risk. Certain major decisions such as changes in the existing lines of business and the disposition of profits may be subject to the Islamic bank's consent. The Islamic bank, as a partner, has the right to full access to the books and records, and can exercise monitoring and follow-up supervision. Nevertheless, the directors and management of the company retain independence in conducting the affairs of the company.

These conditions give the finance many of the characteristics of non-voting equity capital. From the viewpoint of the entrepreneur, there are no fixed annual payments needed to service the debt as under interest financing, while the financing does not increase the firm's risk in the way that other borrowings do through increased leverage. Conversely, from the bank's viewpoint, the returns come from profits - much like dividends - and the bank cannot take action to foreclose on the debt should profits no eventuate.

The character of non-voting equity also attaches in the Islamic banking depositors, thereby it is a logical thought to provide the mechanism for depositors to have access to the management of the bank to which they put their financial resources. In addition, this high portion of the bank's funds can be treated as "equity-like capital" that may implicate to a

different sort of capital adequacy standard. Again it leads to different set of regulation to consider should the Islamic banking system expected to excel in showing its superiority.

The central to such a framework is the *Shari'a* Advisory Council and the internal controls which support it.

### 4.3. Shari'ah Advisory Council

According to the guideline (GPS1) of Islamic banks, the latter is required to set up a *Shari'a* Advisory Council (SAC) to supervise its operations to ensure that those operations comply with the rules of *shari'a*. The SAC advises the directors on matters pertaining to the operational issues of the Islamic bank. The SAC also takes the views of *Shari'a* Committees of relevant authorities such as Bank Negara Malaysia and Securities Commission from time to time on issues relating to the industry.

Furthermore, for an Islamic bank to be licensed under the IBA act, the bank must satisfy all the conditions under section 3(5) of the IBA act, namely, that the banking business which the bank desires to carry on will not involve any element which is not approved by the principle of *shari'a* and that there is in the articles of association of the bank provision for the establishment of a *Shari'a* Advisory Council, whose functions include advising the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the principles of *shari'a*. As regards banks under the Islamic banking system, Bank Negara Malaysia has issued guidelines under section 126 of BAFIA which authorizes these banks to offer the same products and services that is offered by the Islamic banks.

Further, the guideline provides that a *Shari'a* Advisory Council whose members would be made up of Muslims religious scholars shall be established to advise the bank on the operation of its banking business. The Council shall have a minimum of three and a maximum of seven members, whose appointments shall be acceptable to the relevant government minister for a term not exceeding two years, and each member is eligible for reappointment.

The duties and responsibilities of SSC are to review, appraise and advise the Directors on the operations of the Bank's business in order to ensure that they do not involve any element, which is not approved by Islam. The roles of SSC in monitoring the Bank's activities are as follow: (i) Review the products and services to ensure conformity with *Shari'a* requirements; (ii) Deliberate on *Shari'a* issues pertaining to the day-to-day operation of the Bank and provide advice accordingly; (iii) Form opinions on the operations of the Bank on whether they are *Shari'a* compliant; and (iv) (d) Provide training and education on muamalah or Islamic transactions based on *Shari'a* principles.

The *Shari'a* Advisory Council has the authority to scrutinize and approve any documents used by Islamic banks. Nevertheless, although all transactions including products and services offered by it have to be first approved by the Council in order to ensure that they do not involve any element which is not approved by Islam, it is open to any interested party to challenge such transactions as being contrary to Islamic law as there is nothing in the IBA act which states that, once an operation has been approved by the bank's *Shari'a* Advisory Council, it may not be called into question or reviewed by any court of justice.

In fact, the IBA act itself seems to imply that the approval of an Islamic bank's *Shari'a* Advisory Council of any aspect of its operations is not final and conclusive since, under section 11 of IBA act, the Minister of Finance may, on the recommendation of the Central Bank, revoke the license issued to the bank if it is pursuing aims or carrying on operations involving any element not approved by Islam. It seems that the setting up of a *shari'a*

advisory body is a statutory requirement and its function is to ensure that the Islamic bank does not become involved in anything, which is not approved by the *shari'a*.

In current development of Islamic banking practices whereby product and services need to be diversified and expanded, the role of SAC is not only to scrutinize the activity of the bank to ensure *shari'a* compliance but also to proactively develop and innovate new products and services hand-in-hand with the bank management. Therefore position of SAC becomes more strategic for accelerating progress of the banks. It may be no longer relevant to just put the SAC as a rubberstamp for *shari'a* compliance procedure. In this regard the argument whether SAC should be posed as part of the management or independently need a serious consideration for the sake of good corporate governance which is consistent with *shari'a* principles.

## 5. Conclusions

Islamic Law has been in existence for more than fourteen centuries however, it has been up-and-down in the implementation through historical development due to many causes. Even for laws related to finance, such as profit-loss-sharing mechanism which was well-known as *commenda*, they have been there before the birth of Islamic era. Based on the Islamic Teachings on transactions which have a strong distinctive character of non-*ribawi*, Islamic laws and finance is believed to expose a more sound and healthy economy provided they are implemented properly taken into account all necessary spirit, rules, regulations, and institutions.

The fact that under Islamic law on transactions there are various types of contracts, from contract of sales and purchases, contract of usufructs such as leasing, contract of sharecropping, partnerships and equity participation. Islamic banking and finance establishments are endowed with a precious set of law derived from the divine sources of *al Qur'an* and *al hadith*. It is a huge challenge to implement Islamic laws and finance as Islamic as possible due to its universal positive impact on the welfare of the human beings.

Distinctive character of Islamic banking and finance relies mostly on the profit and loss sharing mechanism which contains the cooperative spirit needed by human beings as altruistic creatures. This mechanism is carried out through several types of contracts such as *mudharaba* (profit-sharing), *musharaka* (partnership), *muzara'a* (sharecropping). In addition there are many type of contracts of non profit and loss sharing, such as *murabaha*, *bay' bithaman 'ajil*, *istisna*, *ijara*, *kafala*, etc.

This paper has been discussing that departing from cooperative spirit, the development of equity partnership instruments in the financial system necessitates a different set of regulation and institutions in order to achieve Islamic goal through economic/financial activities. For instance, it has been argued that application *mudharaba* deposits product in Islamic banking needs some sort of modification on the institutional aspect to allow depositors a limited access to the management of the bank. It is aimed at balancing the willingness of depositors to share the bank's business venture, i.e. profit and loss, and their role as a "quasy" shareholder due to their financial capital contribution. A model like "non-voting" right may be considered to develop.

Meanwhile for the application of *mudharaba* and *musharaka* in financing side of the bank, it has also been argued that some sort of institutional change be needed. This change aims at providing more enforcement to transparency of conducting business especially involving profit and loss sharing financing scheme. This is to prevent any deceptive practices such as miss-reporting from occurrence that may cost financial provider (*shahibul maal*) of unfair financial profit/loss.

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