

AN EXPLORATION OF BANKS' MANAGERS' PERCEPTIONS TOWARDS EQUITY-BASED FINANCING PRACTICES IN MALAYSIA

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Accepted date: 13-10-2018

Published date: 17-03-2019

To cite this document: Mohamad, S. N. A., Basah, M. Y. A., & Aziz, M. R. A. (2019). An Exploration of Banks' Managers' Perceptions Towards Equity-Based Financing Practices in Malaysia. *International Journal of Accounting, Finance and Business (IJAFB)*. 4(17), 22-31.

Abstract: *The aim of this paper is to explore the banks' managers' perceptions towards equity-based financing practices in Malaysia. The study uses qualitative approach to explore in detail their perceptions as well as the experiences towards equity-based financing practices in Islamic banking approach. In-depth interviews with Islamic banks' managers in Malaysia and thus phenomenological strategies are used in analyzing the data. It is concluded that the interviewees have considerable perceptions towards equity-based financing practices and this paper proposed the future work of research.*

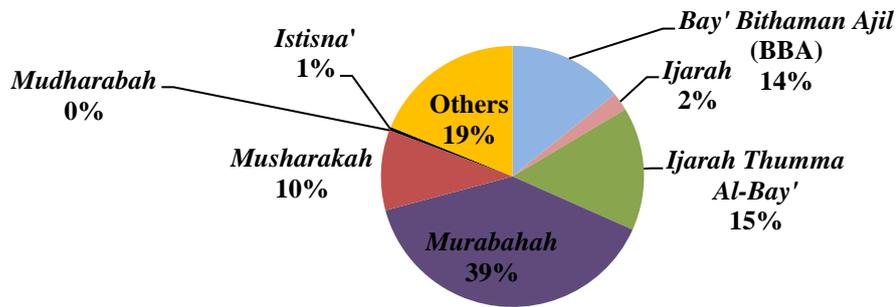
Keywords: *Equity-based financing, Musharakah, Mudharabah, Business & Management, Islamic Banking, Islamic Finance.*

Introduction

Equity-based financing contracts are part of the Islamic financial system that it's initiate the concept of joint venture whereby the contracting parties participate in the business right from its inception and continue to be partners until the end of the business when all the assets are liquidated. It consists of two (2) types of contracts- *Musharakah* and *Mudharabah*. The uniqueness of these contracts offers the concept that the Islamic banks assume the risks of the borrower's business and share in the profits and losses of that business. Also, its offers participating concepts and profit-sharing society oriented which in return it uphold the concept of justice ('*Adl*) and the eradication of oppression (*Al-Qada'u 'alal Zolimi*) (Mohammed & Syahidawati Shahwan, 2013).

However, the practice of these types of financing in Malaysia are not as much of involved by Islamic banking institutions (Aisyah Abdul-Rahman & Syifa Mohd Nor, 2016). Although the concept of *Musharakah* and *Mudharabah* are presently practiced, the number in term of

financing are very small compared to debt-based financing such as *Murabahah*, *Ijarah*, *Bay' Bithaman Ajil* (BBA) and *Istisna'* (Bank Negara Malaysia, 2017; Aisyah Abdul-Rahman & Syifa Mohd Nor, 2016).



Source: Bank Negara Malaysia (2017)

Figure 1: Monthly Statistics of Total Aggregate Financing of Islamic Banking

According to present monthly statistics by end of October 2017 of Central Bank of Malaysia (BNM), only 10% of the total aggregate financing of Islamic banking contributed to the equity-based financing practices as showed in figure 1 above.

One of the main reasons of least involvement in these types of financing as discussed in literatures are because of it approaching to greater complexities compared to debt-based financing (Norfaizah Othman et al, 2015), high risks exposure (Izhar, 2010; Irawan, 2012), challenges in pre-approval stage of financing (Aisyah Abdul-Rahman & Syifa Mohd Nor, 2016) and inconsistency in terms of concept of risk-sharing (Mirakhor, 2010; Sulaiman, 2017).

In Addition, there is inadequacy on proposition in equity-based financing contracts since unbalance practices in terms of theory of balance sheet (Izhar, 2010; Irawan Febianto, 2012). For instance, on the liabilities side banks practice to accept deposits on the basis of PLS, however on the assets side banks diverge most of the theoretical model only.

Therefore, the purpose of the study is to explore the perceptions of banks' managers towards equity-based financing contracts in Malaysia in terms of their difficulties in handling these types of contracts and then to explore potentiality in implementing these types of contracts. Hence, the effective equity-based financing framework will be deployed in this study as one of the contribution on knowledge after ascertain the further clarification and justification from the respondents which based on the results from their perceptions. This further will contribute to a better Islamic financial practices development in Malaysia.

Literature Review

The needs of equity-based financing for Islamic banking system have become one of the necessities in approaching reward-sharing elements which related to risk-sharing among the transaction parties. It needs also would increase the value and performance of Islamic banks and make them resilient to crisis.

To date, empirical research in equity-based financing contracts failed to convince that these types of contracts are approaching low level of contribution. As such, there are negative testimonies on the outcomes of low level of contributions. The case in Malaysia, these types of contracts recently contributes only 10 percent as reported by Bank Negara Malaysia (2017).

There are many reasons on low involvement discussed in the literatures. It includes aspects of *Shariah*, legal, operational and risk. As such, these practices of equity-based financing contracts pursued the character but not the soul (essence) of Islam (Mansor et al., 2015)

In terms of *Shariah*, there are inconsistencies in debt-based and equity-based financing which are based on concept of risk-sharing contributes to less participation in the contracts. Aisyah Abdul-Rahman & Shifa Mohd Nor (2016) stated that financing under equity-based could promote the cooperation in business through risk-sharing. In contrast, Mirakhor et al. (2015) reported that the equity-based financing contract is not exclusively risk-sharing since it not generally friendly with financial intermediaries. Hence at the end it tends to be same with debt-based financing which is more to risk-transfer.

In terms of legal, the inadequacies of the disclosure of Bank Negara Malaysia (BNM) still remain concern. Rashid Ameer et al. (2012) found that only 2 out of 5 of full-fledged of Islamic banks followed BNM guidelines. Lack of expertise, outdated information system structure, shortage of support and lack of trained staff are the factors in inadequacies of disclosure of BNM.

In terms of operational, there are many negative perceptions from the previous study regarding the equity-based financing contracts. As appointed by Hassan (2009), the understanding on the theories and practices in *Musharakah* and *Mudharabah* contracts still remain with confusion and ambiguities. Further research by Kayed (2012) also has the same findings with Hassan (2009) that the difference between the theoretical perspective and the practical implementation of *Musharakah* and *Mudharabah* contracts is in worrying level. In addition, he stated that negative attitude and lack of proper infrastructure of the majority of Islamic banks and also the unwillingness to put up entrepreneurship through the honest implementation of the contracts.

Also, Irawan Febiato (2012) and Nabi (2013) have claimed that operational matters in equity-based financing contracts are in terms of asymmetric information seems to be a triggering stipulation as it arising the transaction costs and moral hazards. As pointed out by Ruhaimi et al. (2013), level of optimal condition (banks as *Rabbul-mal* in asset side and banks as *Mudharib* in liability side) in getting the optimal point in these contracts affects the problems of three dimensions of triggering issues (asymmetric information, moral hazards and transaction costs).

Furthermore, a study from Hasman et al. (2009), Atmeh and Ramadan (2012) and Ruhaimi et al. (2013) stated that considering on operational aspect in equity-based financing contracts can contributes to economic growth. For instance, the implementation of Islamic financial intermediation theory can reduces costs of information as well as transaction and permits risk-sharing and participative intermediation leads to an equitable (*'adl*) and help to resolve a variety of problems such as poverty and unemployment.

Also, a study from Malaysia by Wan Norsyakila Wan Kamarudin and Abdul Ghafar Ismail (2013) pointed out that operational aspects that need to be concerned in equity-based financing contracts are asymmetric information, moral hazards and transaction costs. By considering theory of financial intermediation in Islam, these contracts are capable to maximize profit and provide incentive to the customers if actual profit (π) for Islamic banks (b) must be equal or more than πb . ($\pi * b \geq \pi b$). So, probability of profit and amount of asset that Islamic bank invested (h) should be $h > 0$.

Moreover, operational aspect in equity-based financing contracts are concerned by Muhammad (2014) and Hamza (2015) as they pointed out that lack of management's monitoring and controlling technique and the lack of risk-aversion approach of top management not only affects the low level application, but also with the communal factors such as moral hazard and high risk. Despite of these results, previous studies have the same discussion and argumentation that major causes of marginal use of these contracts of financing inherently more difficult to operate because of moral hazard, high risks, operational difficulties and adverse selection (Ainulashikin Marzuki & Worthington, 2015).

Additionally, research by Irawan Febianto (2012) and Wan Norsyakila Wan Kamarudin & Abdul Ghafar Ismail (2013) revealed that in the operational side in terms of theory of balance sheet for PLS arrangement contracts, a majority of Islamic banks in Malaysia focus on the liabilities side (*Mudharabah* deposit account) as it is common practice to accept deposits on the basis of profit-and-loss sharing (PLS), but it is on the assets side that deviates most of the theoretical model. One of the deviations is on the low contribution level in profit-and-loss sharing (PLS) arrangement. This show that the PLS paradigm focus on operational side only.

In terms of risk management practices aspect, a study by Suraya Ahmad and Abdul Rahim Rahman (2012) found that liquidity and risk performance of Islamic banks contributes for performance of equity-based financing contracts. While in terms of different types of banking system, the conventional banks are more profitable than the Islamic banks, while the latter is more liquid and less risky especially with respect to risk-weighted capital ratio than the traditional banks (Siti Rohaya Mat Rahim et al., 2015).

Also, there were no major difference between Islamic banks and conventional banks with respect to risk management practices (Javed et al., 2015). Hence, Islamic banks need to determine the intention (*Niat*), purpose (*Al-ghardu*) and amounts of business financing applications to be consistent with the "*Bank's Financing Policy*" so as not to cause any problem in the future (Mohamad Yazis Ali Basah & Mazlynda Md Yusuf (2013); Siti Nor Amira Mohamad et al., 2015). If not, issues in these contracts would be a risk of repayment vagueness which will have emotional impact to the liquidity of Islamic banks.

Additionally, greater complexities and high risk level arising from the nature of specific risks (credit, operational, market and liquidity) also one of the reasons in approaching less participation in these types of contracts (Izhar, 2010; Irawan Febianto, 2012; Norfaizah Othman et al. 2015).

Methodology

To achieve the aims of the study, this paper attempts to apply qualitative research approach which based on several interviews as its primary data sources. The study was done on five (5) respondents (known as banks' managers) from five (5) different types of Islamic banks in Malaysia; namely Kuwait Finance House, Public Islamic Bank, Affin Islamic Bank, RHB Islamic Bank and HSBC Amanah. A, B, C, D and E are used as synonyms for the respondents. The structure of the responses follows the structure of the interview guideline coherently. The responses will be given as reported speech (using the exact words of the respondents) and in some cases using his, her, us, we and they which all refer to the respondents.

Besides, the selection of the respondents is depending on some specific criteria. Well-educated and total years of experiences are the specific criteria with the ability to understand and respond to detailed questions concerning specific matters pertaining of their perceptions. Tape recorder is used to access the respondent's responses and it was ranging from 15 to 30 minutes.

Phenomenological approach is used to analyze the data as this allows the respondents to express their perceptions based on their experiences. Following table shows the summary of respondents: -

Table 1: Summary of Respondents

| Respondents | Gender | Name of the Bank | Total Experiences | Education Level |
|--------------------|---------------|-------------------------|--------------------------|------------------------|
| A | Male | Kuwait Finance House | 5 Years | Degree |
| B | Male | Public Islamic Bank | 7 Years | Master |
| C | Female | Affin Islamic Bank | 9 Years | Master |
| D | Female | RHB Islamic Bank | 6 Years | Degree |
| E | Male | HSBC Amanah | 10 Years | PhD |

Analysis of Interviews Responses

This section discusses deeply the responses from the interview's responses and two (2) important issues found which includes of perceptions towards challenges in handling equity-based financing contracts and potentiality in implementing these contracts in future.

Perceptions towards Challenges in Handling Equity-based Financing Practices

As seen in the interview questions in appendix, they were asked questions of what are the perceptions towards current practices. As the respondents may conjure up more than one image or word, table 2 summarizes their perceptions on the challenges:

Table 2: Words and Concepts Associated with Challenges in Handling Equity-based Financing Practices

| Words and Concepts Associated with the Challenges | Total |
|--|--------------|
| High Risks | 5 |
| Pre-approval (Evaluation Process) | 5 |
| Demand | 3 |
| Legal Framework | 4 |

Based on table 2 above, the two (2) most common word associations with challenges were "high risks" and "pre-approval (evaluation process)" by respondents. Respondents B and E mentions: -

"Compared with other types of financing, Musharakah and Mudharabah constitute a very small portion of our assets. These contracts are high risk level especially in operations and rate of return"

-(Respondent B)

"One of our major challenges in handling these types of financing is during the evaluation process. We needs to find the right partner as to ensure the shared business is generating profit so that they can remain competitive"

-(Respondent E)

On top of that, other common words associated with challenges were “demand” and “legal framework”. To simplify, figure 2 below stated the challenges in handling the contracts:

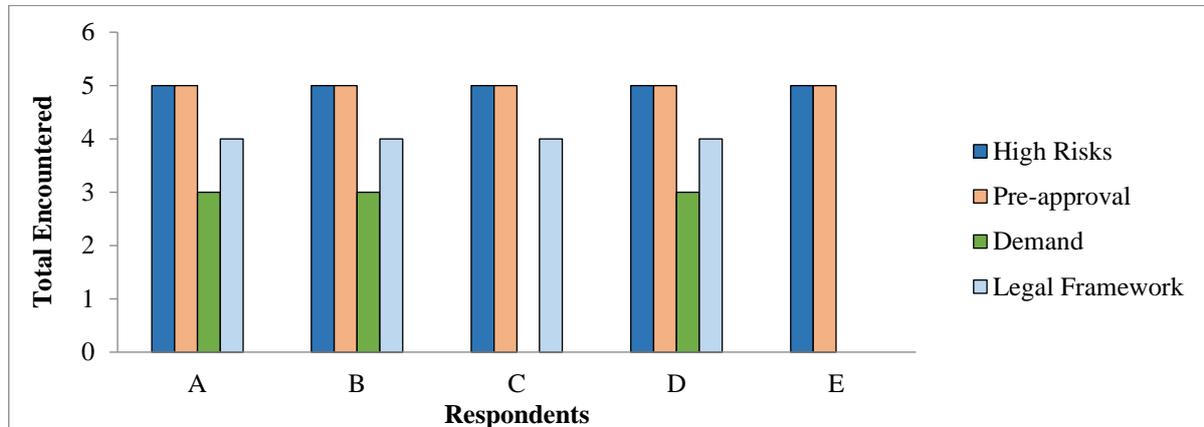


Figure 2: Challenges in Handling the Equity-based Financing

Perceptions on Potentiality in Implementing Equity-based Financing Practices

As seen in the interview questions in appendix, they were asked questions of what are the perceptions on the potentiality in implementing equity-based financing. As the respondents may conjure up more than one image or word, table 3 summarizes their perceptions on the potentiality:

Table 3: Words and Concepts Associated with Potentiality in Implementing Equity-based Financing Practices

| Words and Concepts Associated with the Potentiality | Total |
|---|-------|
| Islamic Elements Practices | 5 |
| Islamic Banks as Genuine Entrepreneurs | 1 |
| Realization of <i>Shariah</i> -based | 5 |
| Subsidiaries Establishment | 3 |
| Government Intervention | 4 |
| Public Awareness | 4 |

Based on table 3 above, the two (2) most common word associations with potentiality were “Islamic elements practices” and “realization of *Shariah*-based” by respondents. Respondents A and C mentions: -

“Musharakah and Mudharabah have potential to grow further if the contracting parties practicing the Islamic elements such as Adl’, Amanah, Istiqamah and Tawakkal in doing business”

-(Respondent A)

“Islamic banks should shift their perception on offering products based on Shariah-compliant such as marked-up pricing financing to Shariah-based through the practicing profit-and-loss sharing (Musharakah and Mudharabah).”

-(Respondent E)

On top of that, other common words associated with potentiality were “Islamic banks as genuine entrepreneurs”, “subsidiaries establishment”, “government intervention” and “public awareness”. To simplify, figure 2 below stated the potentiality in implementing the contracts:

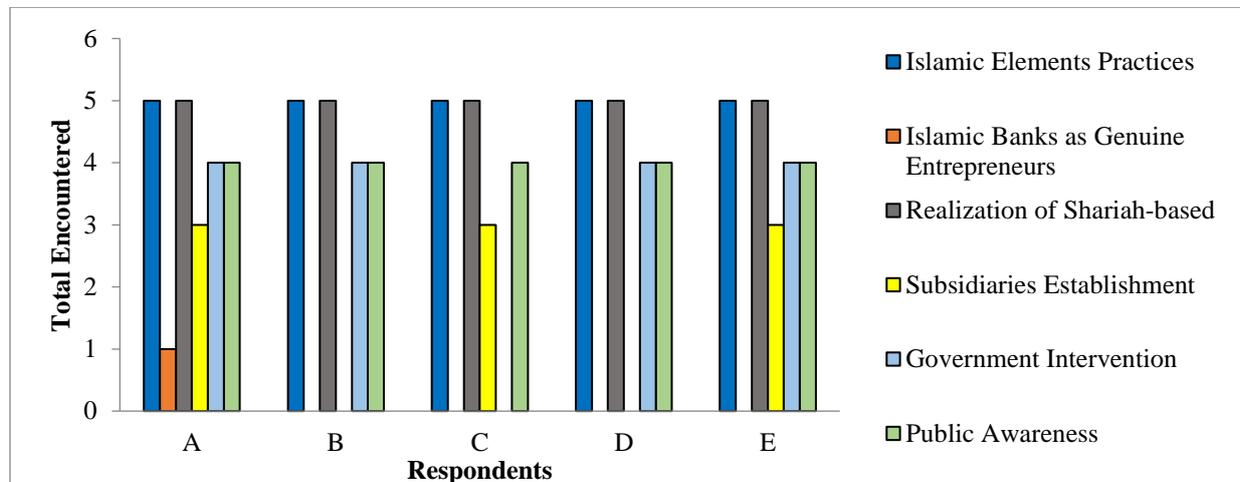


Figure 3: Potentiality in Implementing the Equity-based Financing

Findings

The analysis from banks’ managers’ perceptions comes into the sense. There are several main themes found. It includes of the perceptions on the challenges that they are facing and the potentiality in implementing the contracts. All of the respondents answered the questions as to achieve the goals of research study. Likewise, all of the respondents positively associated on their perceptions.

It was found that the high risks, issue in pre-approval (evaluation process), demand from customers and lack of legal framework contributed to challenges that they are facing in managing the contracts. Different views from the respondents showed more proficiency with their experiences in handling the Islamic banks products.

This study also found that a positive responses pertaining to the potentiality in implementing the contracts. The next section presents the proposed equity-based financing framework after ascertain the further clarification and justification from the respondents.

Equity-based Financing Framework

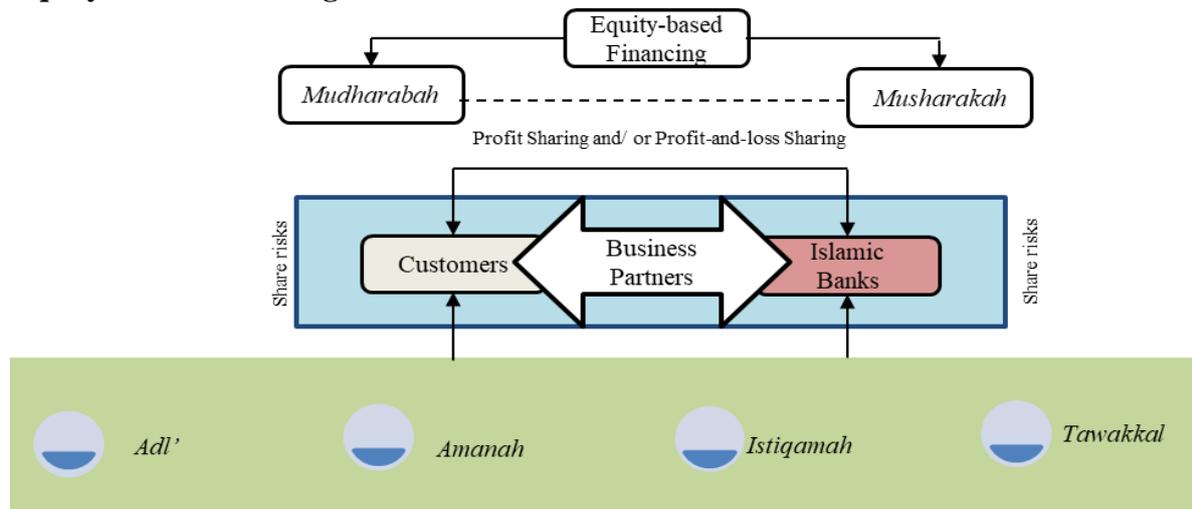


Figure 4: Proposed Equity-based Financing Framework

Conclusion

The study believes that the consequences and outcomes of this study would have been more elaborate, or more dissimilar, if the study had more interviewees since the banks' managers' who were interviewed were few in number, and they were from a specific geographical area.

Honestly, it was in the beginning of all very stressful to ought to the ones which the study interviewed and contacts with respondents yielded no results. Thus, the results and recommendations should not be considered as expert or professional advice but as a mere academic exercise to take along forward what have the study found out in the progression of this work and what have the study contemplate which based on the exploration, analysis and previous literatures read that banks practitioners be duty-bound to do in order to improve their results.

For future work of study, it is good to explore in-depth regarding the Islamic elements practices in handling the Islamic financing practices especially when dealing with equity-based financing since the contracts are more complex compared with other types of financing. The perceptions and views from *Shariah* advisers are needed in future work of research as it can contemplate more on Islamic elements considerations and improve the development of the framework.

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Interviews Questions

General Questions:

1. Do you accept that I put your name in the study?
2. What is your name?
3. What is your work position in the industry?
4. How long have you worked in the industry? What is your working experience?
5. What is your educational qualification?

Interview Questions Regarding Banks' Managers' Perceptions:

1. What are your perceptions towards challenges in handling equity-based financing practices in Malaysia?
2. What are your perceptions on potentiality in implementing equity-based financing practices?

Conclusions:

1. What change do you hope can take place in the banking industry?
2. Do you have anything to add?
3. Can I get back to you in case of any further questions?