Academic Articles

JURISTIC ANALYSIS OF THE PROFIT DISTRIBUTION METHOD OF MALAYSIAN ISLAMIC BANKS

*Amir Shaharuddin**

Abstract

The relationship between depositors and Islamic banks is governed by a mudarabah contract. In principle, the former are regarded as rabb ul-māl (capital providers) while the latter are considered as muḍārib (entrepreneurs). Profit generated from the business will be shared between both parties according to a pre-determined ratio. The present article reviews some Sharīʿah issues which arise from the profit distribution method implemented in Malaysian Islamic banking institutions. It examines to what extent the current practices fulfil the principles and the ethical framework of the mudarabah contract as propounded by the classical jurists. The article analyses the justifications of the local Sharīʿah scholars in modifying the doctrine to adapt to the modern banking business. This includes their decisions in authorising the Weighted Method (WM), the Profit Equalisation Reserve (PER), the indicative profit rate and the interim profit payment.

Keywords: Sharīʿah issues, Islamic banking, profit distribution method.

I. INTRODUCTION

Researchers have conducted several critical studies regarding the profit distribution method in Islamic banks. They are particularly

* Amir Shaharuddin, is a Senior Lecturer at the Faculty of Economics and Muamalat at the Islamic Science University of Malaysia (USIM). He can be contacted at amir@usim.edu.my.

interested in assessing the ability of the Islamic banks in establishing a more equitable wealth distribution system. Perhaps one of the earliest empirical studies on the subject was conducted by N. Ahmad and S. Haron. Based on an analysis of 10 years of financial statements of 15 Islamic banks from various Muslim countries, they found that there was a positive relationship between the interest rate of the conventional banks and the profit rate of the Islamic banks. Their study indicates that the former has influenced the latter (Ahmad & Haron, 1998). Bacha, in a later study, also obtained similar findings. Focusing on the Malaysian commercial banks' (Islamic and conventional) rate of returns for a period of 13 months, he again proved that the changes in the conventional banks' interest rate had an impact on the rate of return of the Islamic banks (Bacha, 2004).

Such a relationship between the two rates of return has raised another issue. Since the profit rate is always tied to the interest rate, depositors are arguably receiving lower rates as compared to the actual profit generated by the Islamic banks (Hasan, 2009). The matter seems more problematic when researchers found that there was significant variance between profit paid to the depositors and shareholders even though their money was invested in similar *muḍārabah* investments. As is generally known, the *muḍārabah* capital in the Islamic bank comprises depositors' money and shareholders' funds. Combining the capital together, Islamic banks put them in various kinds of investments to generate profit. In principle, profit generated from the investments should be distributed between the Islamic bank and the capital providers according to a pre-determined ratio.

As capital providers, the depositors and the shareholders should receive similar rates of profit for their capital contribution. However, analysis on the returns received by depositors and shareholders of Islamic banks in Malaysia reveals a different scenario. It was found that the return on equity (ROE) given to the shareholders was higher than the return on *muḍārabah* deposit (ROMD) given to the depositors. On average the variance between the ROE and the ROMD was 3.69 percent (Rosly & Zaini, 2008). Why is there a distinction between the two rates? By right the depositors are supposed to get a higher profit rate since they collectively contribute larger sums of money as compared to the shareholders.

Considering the above issues, I argue that there is a need to review how *muḍārabah* profit is distributed by the Islamic banks. Based on the earlier findings: (1) the existence of conventional banking theories in determining the rate of return of Islamic banks, and (2) the unequal treatment of the depositors, the current practice of profit distribution in the Islamic banks appears to be surrounded with Sharīʿah issues. The present article aims to discuss these issues by highlighting the Malaysian Sharīʿah scholars' decision to permit the practices of the Weighted Method (WM), the Profit Equalisation Reserve (PER), the indicative profit rate and the interim profit payment.

This article is organised into six sections. After the Introduction, Section Two explains briefly the classical concept of the *muḍārabah* contract as propounded by the classical jurists. Next, Section Three describes the main rules of how *muḍārabah* profit should be distributed. A comprehensive understanding of these rules is required as the basis of evaluating the present profit distribution method in the Malaysian Islamic banks, which is explained in Section Four. Section Five then analyses to what extent these practices comply with the rules established in the classical *muḍārabah* contract. Lastly, Section Six concludes the preceding discussion.

II. THE DEFINITION OF *MUḌĀRABAH* AND ITS SALIENT FEATURES

In the classical *fiqh* texts, *muḍārabah* is also known as *al-qirāḍ*. Both terminologies indicate a similar meaning; the former was used by people in Iraq while the latter was used by people in Ḥijāz. In relation to this geographical basis, the Ḥanafīs and Ḥanbalīs usually referred to the contract as *muḍārabah* whereas the Mālikīs and Shāfiʿīs referred it as *al-qirāḍ*. The term *muḍārabah*, literally, is derived from the expression *ḍarb fī al-arḍ* which means "making a journey". It is called *muḍārabah* because the contract normally requires the entrepreneur to travel, transporting merchandise from one place to another.

Meanwhile, the origin of *al-qirāḍ* was derived from two possible words: *qaraḍ* and *muqāraḍah*. The former means cutting and the latter means equality. *Al-qirāḍ* was said to be derived from *qaraḍ* because the investor and the entrepreneur will be cutting their deposition of money for each other. At the beginning of the contract, the investor will cut some portion of his money and entrust it to the entrepreneur. When the business is to be liquidated, the entrepreneur will cut some portion of profit generated from his work to share with the investor. On the other hand, *al-qirāḍ* was possibly derived from *muqāraḍah* due to the element of equality embedded in the contract. *Al-qirāḍ* is viewed as an equal contract since it requires both contracting parties to share a certain degree of risk before they can enjoy any business profit (al-Shirbīnī, 1958, p. 309).

In spite of the different terminologies, the classical jurists were unanimous in their legal definition of the contract. They referred to *muḍārabah* or *al-qirāḍ* as a contract between two parties; one (called the investor) entrusts money to the other party (called the entrepreneur) to commence a business venture. Any realised profit will be shared between the two parties based on a profit ratio decided at the beginning of the contract.

The following are the legal definitions of *muḍārabah* described by the prominent jurists of the four Sunnī schools of law:

1. Al-Sarakhsī of the Ḥanafīs explained, "*Muḍārabah is derived from ḍarb fī al-arḍ; it is called that because the entrepreneur is entitled to the profit derived from his efforts and work, he is the investor's partner in profit, capital and business decision making*" (al-Sarakhsī, 1906, p. 18).
2. Al-Khalāl of the Mālikīs stated, "*Qirāḍ is an act of appointing an agent (tawkīl) to conduct business by giving (the entrepreneur) cash for some return of the business profit*" (al-Dusūqī, n.d. p. 518).
3. Al-Nawawī of the Shāfiʿīs wrote, "*Qirāḍ or muḍārabah takes place when a man is handed money to trade with, and (any realised) profit will be shared between the two parties*" (al-Shirbīnī, 1958, p. 309)
4. Ibn Qudāmah of the Ḥanbalīs explained the contract thus: "*A person gives someone his money to trade with, and any realised profit will be shared between the two parties based on a pre-agreed ratio*" (Ibn Qudāmah, 1999, p. 132).

The above legal definitions clearly indicate that a valid *muḍārabah* contract requires five essential elements. They are the investor (*rabb ul-māl*), entrepreneur (*muḍārib*), capital, work and profit. In the following section, we shall discuss the detailed rules pertaining to the profit distribution method as described by the classical jurists. In analysing the rules, our aim is to formulate the principles and the general guidelines of how profit was distributed in a classical *muḍārabah* venture. We are fully aware that not all of the detailed rules are applicable in these modern times. However, we do believe that there are some principles in distributing the *muḍārabah* profit which are binding.

III. THE CLASSICAL RULES CONCERNING THE PROFIT DISTRIBUTION METHOD IN A MUḌĀRABAH CONTRACT

The classical jurists' discussion regarding the provisions of *muḍārabah* profit can be broadly divided into two aspects. The first aspect relates to the proportional division whereas the second concerns the distribution method.

It was agreed unanimously by the jurists that profit in *muḍārabah* should be distributed in ratio or proportion. The proportion must be decided at the beginning of the contract by both contracting parties. The distribution of *muḍārabah* profit in the form of fixed amount is not accepted and will invalidate the contract. The fixed amount of profit is prohibited because it leads to the inequitable situation of sharing the proceeds of business. This could happen in various cases. For example, suppose an investor agreed to embark on a *muḍārabah* contract and promised to pay his entrepreneur a fixed 100 *dirhams*. After some time, the entrepreneur came back and declared that the business did not make any profit except the amount of his guaranteed income. In this case, all the profit will go to the entrepreneur and the investor will get nothing. And it is even worse if the profit is claimed to be less than 100 *dirhams*. In order to keep his promise, the investor has to use his own money to pay the entrepreneur (Sarakhsī, 1906, p. 23). Knowing the limit of his income, the entrepreneur will have no incentive to maximise *muḍārabah* profit for the sake of an investor. In contrast, the proportional division of profit will avoid such a problem. This is because the shares of the concerned parties will depend on the actual amount of profit realised from *muḍārabah* business. For the entrepreneur, the more profit declared from the business, the larger the amount of money he would receive.

The classical jurists did not determine the minimum and the maximum ratio of profit required in a *muḍārabah*. It depends entirely on the discretion of the investor and the entrepreneur at the time the contract is being negotiated. The cases discussed by the jurists in the classical legal texts were theoretical in nature. They are not indications of the prevalent practice of *muḍārabah* of the medieval period. The most frequent ratio mentioned was 50:50. Perhaps, the equal division was highlighted in most of the cases to provide simple examples for general readers. It is notable however that the formulaic phrase used by the classical jurists in this subject often begins with the investor's offer. For instance an investor would say to an entrepreneur: "I will entrust to you 1000 *dirhams* in the form of *muḍārabah* on the basis of half the profit". Besides the negotiation element, the phrase demonstrates the investor's position as the dominant party in the *muḍārabah* contract. As the provider of the capital, the investor is the one who makes the offer and stipulates conditions to safeguard his investment. As the working party, the entrepreneur would have no other choice but to either accept or reject the offer. In contrast, the present practice of *muḍārabah* in the Islamic banks illustrates the opposite scenario. Most of the matters, including the provisions of profit ratio are determined by the banks. Depositors do not have the opportunity to discuss the issue with the banks since the *muḍārabah* investment product has become a "take it or leave it" affair offered by the Islamic banks.

The issue of the determination of profit ratio did not raise many disputes among the classical jurists. All of them agreed that the ratio or proportion must be clearly determined and known (*maʿlūm*) as well as spelled out between the two contracting parties. Perhaps the only disagreement in this subject is the case when the contract mentioned only one party would receive the share of the profit. According to the majority of jurists, as the risk of *muḍārabah* must be borne by both the investor and the entrepreneur, so too should the profit of the business be shared. Hence, the Ḥanafīs, Shāfiʿīs and Ḥanbalīs ruled that if all the profit is assigned to the entrepreneur, the capital will be governed on the basis of a loan (*qarḍ*) contract. In this case, the entrepreneur is responsible for returning the full amount of capital and bearing the monetary losses. On the other hand, if it was agreed that only the investor would receive the profit, the agreement would be treated as an *ibḍāʿ* contract (Sarakhsī, 1906, p. 24, Sharbīnī, 1958, p. 312, Ibn Qudāmah, 1999, p. 142). This means the entrepreneur would not be liable to any risk at all in the deal. However, Mālik was of the opinion that a *muḍārabah* contract remains intact even when it was agreed that all the profit will be given exclusively to the entrepreneur. It was reported that Mālik was asked about a similar case and he replied: "That is very good and surely no problem" (Saḥnūn, 1966, pp. 89-90).

After discussing the proportional division of *muḍārabah* profit, we will now move on to the issue of the profit distribution process. It begins with the requirement for the entrepreneur to return the capital to the investor. The jurists asserted that as *muḍārabah* could not begin without the investor relinquishing control over his capital, so too, the contract could not be liquidated unless the entrepreneur restored the capital to the physical possession of the investor (Udovitch, 1970). The return of capital is crucial to determine the *muḍārabah* profit. This is because the profit of the contract is defined as any excess from the capital. Hence, after all the capital has been restored, any remaining money will be divided by both parties according to the pre-agreed proportion. Ibn Qudāmah explained the rule as follows:

> And there is no profit for the entrepreneur until he restores the capital. This means the entrepreneur is not entitled to anything from the business until he returns the capital to the investor, and when there is loss and profit, the former will absorb the latter, irrespective of whether they occur at the same or different times. This is because profit means any excess from the capital, and anything which has no excess has no profit (Ibn Qudāmah, 1999, p. 165).

If for some reason the investor and the entrepreneur divided the profit without returning the capital, the original *muḍārabah* was considered as continuing in force. Al-Sarakhsī illustrated a similar case to explain the position of the Ḥanafīs in this matter. Suppose an investor entrusted 1000 *dirhams* to an entrepreneur. From the capital given, the entrepreneur managed to earn an additional 1000 *dirhams*. Then, both of them distributed the profit equally and took 500 *dirhams* each. The capital remained in the possession of the entrepreneur and he continued the business with it. After that, the business was unsuccessful and made losses. According to Sarakhsī, the previous distribution of profit is invalid. Therefore, the 500 *dirhams* which the entrepreneur took as profit is to be considered as capital. The entrepreneur should return the money to the investor and only then would the *muḍārabah* be dissolved. The insistence on returning the capital is based on a *ḥadīth* of the Prophet (peace be upon him) in which he was reported to have said: "A Muslim is like a trader; just as the trader's profit is not complete until his capital is restored, so too a Muslim's recommended act of worship is incomplete until he performs the obligatory worship" (Sarakhsī, 1906, p. 105).

The case above also indicates that the Ḥanafīs recognised the right of the concerned parties to share the expected return of the *muḍārabah* business. In other words, although the contract is not yet dissolved, the investor and the entrepreneur are allowed to take their projected shares. However, as the original *muḍārabah* business is still continuing, the profit taken is conditional. The profit taken is subject to the performance of the *muḍārabah* business after the distribution. If there is loss incurred in the subsequent business, the entrepreneur has to return the profit as part of the capital. The most prevalent view of the Shāfiʿīs (*al-aẓhar*) agreed to this ruling (Sharbīnī, 1958, p. 318). The majority of Shāfiʿīs did not consider any sales or commercial contracts executed using money from *muḍārabah* expected profit as legally binding. In a theoretical case study, they refused to recognise the act of the entrepreneur who bought and freed a slave with such profit. They argued that the entrepreneur did not yet own the expected profit; thus, he had no right to free the slave (al-Nawawī, 1966, p. 210).

However, the Ḥanbalīs recognised the absolute ownership of expected profit taken from a continuing *muḍārabah* business. In justifying the rule, the Ḥanbalīs made an analogy with a *musāqāh* contract.[1] As the worker in this contract owns his shares, starting when the fruit is beginning to grow, the entrepreneur also has the right of ownership from the expected return of *muḍārabah* business (Ibn Qudāmah, 1999, p. 164). On the other hand, the Mālikīs seemed to be the strictest school in this matter. Unlike the Ḥanafīs and Shāfiʿīs, they prohibited the distribution of expected *muḍārabah* profit completely. Mālik, in particular, did not permit the entrepreneur to take his expected shares without the presence of the investor. He stressed that the distribution of profit should be carried out in the presence of the investor who receives his capital in full amount. Even if the investor was present during the distribution of profit but did not physically possess the capital, the distribution process is not considered valid (al-Bājī, 1999, p. 119).

It is important to bear in mind that the above classical jurists' discussion was made on the basis of an uncomplicated *muḍārabah* contract. It usually took place between two parties and was carried out to finance a specific trade project. Hence, the determination of profit for each concerned party is relatively easy. However, *muḍārabah* in Islamic banks is practised in a vastly different business situation. Islamic banks receive *muḍārabah* capital from many depositors at different times. The money is then invested in various projects which vary in their completion periods. So how can the banks determine the actual profit for the depositors? The task seems more problematic given the right of every depositor to withdraw part or all of his money at any time. In addition to that, because of the statutory deposit regulation, not all depositors' money is invested. Some of the money is kept as reserves in the Central Bank. Hence, a similar question arises of how the Islamic banks determine the actual profit for the depositors in this situation (El-Tegani, 1996).

The above issues are the challenges faced by the Islamic banks in implementing the classical *muḍārabah* theory. Certainly, the present Sharīʿah scholars in the Islamic banks are required to make new *ijtihād* to adapt the classical theory to modern banking practices. We will examine this issue in the following sections.

---

1 Refer to partnership contract between a farm owner and a worker to maintain and water trees with the fruits being shared between the two parties.

IV. THE PROFIT DISTRIBUTION METHOD AS IMPLEMENTED BY MALAYSIAN ISLAMIC BANKS

The most common profit distribution method adopted by Islamic banks in Malaysia is known as the Weighted Method (WM). Table 1 below shows an example of its application, in which an Islamic bank is supposed to distribute RM5800 of profit from a total deposit of RM900,000 to depositors based on a 50:50 profit sharing ratio.

Table 1: An Example of the Weighted Method in Islamic Banks.

Deposit Placement Tenure	Monthly Average Balance	Weighted Average Ratio (WAR)	Weighted Proportion of Profit	Distributable Profit		Depositors' Portion			Bank's Portion		
				Actual Gross Profit Allocated	Actual Gross Rate of Return	PSR	Profit Amount	%	PSR	Profit Amount	%
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)	(viii)	(ix)	(x)	(xi)	(xii)
1	100,000	0.80	80,000	515.56	6.74	0.50	257.78	3.37	0.50	257.78	3.37
3	100,000	0.85	85,000	547.78	7.16	0.50	273.89	3.58	0.50	273.89	3.58
6	100,000	0.90	90,000	580.00	7.58	0.50	290.00	3.79	0.50	290.00	3.79
9	100,000	0.95	95,000	612.22	8.00	0.50	306.11	4.00	0.50	306.11	4.00
12	100,000	1.00	100,000	644.44	8.43	0.50	322.22	4.21	0.50	322.22	4.21
15	100,000	1.05	105,000	676.67	8.85	0.50	338.34	4.42	0.50	338.34	4.42
18	100,000	1.10	110,000	708.89	9.27	0.50	354.44	4.63	0.50	354.44	4.63
24	100,000	1.15	115,000	741.11	9.69	0.50	370.55	4.84	0.50	370.55	4.84
36	100,000	1.20	120,000	773.33	10.11	0.50	386.66	5.05	0.50	386.66	5.05
	900,000		900,000	5800.00			2900.00			2900.00	

Source: http://www.money3.com.my/Profit Distribution, Retrieved on 8 Jun 2009.

The underlying principle of the WM is the use of the Weighted Average Ratio (WAR). The WARs are applied based on the assumption that long term deposit placement gives more opportunity for the bank to generate high profit. For example, a 12-month deposit could be invested in various profitable investments with higher returns as compared to a 1-month deposit. Based on this premise, as indicated in column iii, a higher ratio is assigned to longer deposit tenure. The WAR ratios are then multiplied by monthly average balance (column ii) to determine the weighted proportion of profit in column iv. In order to calculate the actual gross profit (column v) of each deposit, the following formula is applied: balance in column iv divided by total in column iv multiplied by RM5800 of profit. This means the gross profit allocated for a 12-month deposit for instance is:

$$\frac{100{,}000}{900{,}000} \times 5800 = \text{RM}644.44$$

After that, the gross percentages in column vi are computed by dividing the profit of RM644.44 by the original deposit amount in column ii, then multiplied by 100, then multiplied by 365 days in a year and divided by the number of days in the month, say 31. Hence, the rate of return of the 12-month deposit is:

$$\frac{644.44}{900{,}000} \times 100 \times \frac{365}{31} = 8.43$$

Having determined both the actual gross profits (column v) and their percentages (column vi), the profit portions of the depositors and the bank now can be calculated. Since, in our example, the profit sharing ratio (PSR) is agreed at 50:50, the depositors' and the bank's portion is calculated by dividing the gross profit by two (RM644.44 ÷ 2 = RM322.22). The same formula is applied in computing the effective rate of return for both parties (8.43 ÷ 2 = 4.21).

Based on the above example, perhaps we now have a clearer idea as to how the Islamic banks come up with the so-called indicative profit rate. It refers to the rate of return described in percentages (as in column ix) which gives an indication to the depositors regarding the return they may receive from their *muḍārabah* general deposit investment. For instance, a person who opens a *muḍārabah* general account may expect to receive a profit rate of 3.79% for his 6-month deposit. The Islamic banks claim that the indicative profit rate is just a reference of the expected return that would be received by the depositors. The profit rate is quoted based on the regular rates paid to the depositors. The actual profit rate paid to the depositors will be the real profit earned from the banks' business operations. This practice was approved by the Malaysian National Sharīʿah Advisory

Committee (NSAC) in their 9th meeting on 25th February 1998 (BIMB, 2007). In addition to the indicative profit rate, the Islamic banks in Malaysia apply monthly interim profit payments. This means preliminary profit is paid to the account holder each month before the actual term of the contract is due. This practice is permitted by the Sharīʿah Committee of the Islamic banks, for example by the Sharīʿah Committee of BIMB during their 14th meeting on 7th June 1985 (BIMB, 2007).

Beginning in 2004, the Islamic banks in the country introduced another new mechanism in distributing profit for the *muḍārabah* investment. The new mechanism is known as the Profit Equalisation Reserve (PER). The PER was introduced to stabilise the rate of return paid to the depositors (BNM, 2004). In real banking business, the monthly rate of return recorded by Islamic banks throughout a year is inconsistent. This is because an Islamic bank tends to generate a huge profit at the end of its financial year, partly due to the flux of bad debt income, provisioning and total deposits. The pressure of the closure of a bank's financial account makes bankers work harder during this time to generate high profit. Meanwhile, during the middle of the year, such pressure eases and a fairly low profit is produced from the banks' businesses (Chik, 2008). Hence, in order to mitigate the fluctuation of the rate of return, the Central Bank of Malaysia has obliged all the Islamic banks in the country to implement the PER mechanism. The PER allows the Islamic banks to save up to 15 percent of the total gross income in a separate provision. This provision/reserve will be used whenever Islamic banks record a low profit. As such, the PER is viewed as a reserve that is built up in good times to cater to the need in bad times (Ismail & Shahimi, 2006). As argued by the Islamic banks, the PER is vital to ensure a stable and competitive rate of return for the depositors.

V. ANALYSIS OF THE CURRENT PRACTICE OF PROFIT DISTRIBUTION IN MALAYSIAN ISLAMIC BANKS

It is clear that the profit distribution method presently practised in the Islamic banks is different from the rules explained by the classical jurists. The difference exists as a result of the dissimilar business environment in which the *muḍārabah* contract was implemented. As mentioned earlier, during the classical period, *muḍārabah* was applied in circumstances where a capital provider (*rabb ul-māl*) provided the entire capital to an empty-handed entrepreneur. Using the capital, the entrepreneur bought saleable items and tried to sell them for profit. The classical jurists defined profit as any excess from the capital. Hence, in order to identify the excess, the entrepreneur (*muḍārib*) was required to return the capital to the investor when the business was about to be liquidated. Anything which exceeded the capital would be considered as profit and would be shared between the two parties based on a pre-agreed ratio. All these procedures are straightforward because the *muḍārabah* was implemented in a simple business setting.

However, in present Islamic banking practices, the banks receive deposits from customers throughout a year. The deposits are then placed collectively and invested in various types of investments which vary in their completion periods. For example, money deposited in June and July in a particular year is pooled together and invested to buy short-term Islamic securities; one matures in December and the other in April[2].

Although significant efforts have been made to design the WM method in a way that tries to distribute profit in the most equitable manner (given the sophisticated banking business circumstances), in my opinion there are still a number of Sharīʿah issues which need to be addressed. Clearly, the application of the WM method gives emphasis to the investment period rather than to the nature/activity of the investment. The amount of profit which depositors may receive is determined by their deposit placement tenure. The longer the tenure, the higher the rate of return that will be offered. This explains why the rate of return of the *muḍārabah* general investment of the same investment tenure[3] is similar despite the fact that the funds are invested in various types of investments. In principle, the rate of return should vary as different investments carry dissimilar degrees

---

2 Assuming in this example the financial year of the Islamic bank is from April to April each year.

3 For example, all 12-month deposits are given a 3.79% rate of return.

of business risks. Nonetheless, for an Islamic bank, the issue whether one investment is more profitable from another is insignificant. This is because the bank will pool together all the profits made during each year and distribute them based on the weighted average method. As far as the Malaysian Sharīʿah scholars are concerned, this method does not contravene the *muḍārabah* rules since all depositors had given consent to share the profit on the weighted basis. Their approach in solving this problem is similar to the solution suggested by Muḥammad Bāqir al-Ṣadr (al-Ṣadr, 1977).

As duration becomes the crucial factor in determining the depositors' share of profit, the *muḍārabah* investment appears to be different from the conventional deposit investment. In principle, the *muḍārabah* profit should be measured by the nature/activity of the investment rather than its duration. The assumption that long term investment always generates more profit is debatable. If investment is made in the right business it may generate more profit in a short period. The problem with the current system is that it may not distribute the actual profit to the depositors. This is because by mingling together all the profit and distributing them based on the investment duration, the bank may deny some depositors earning a higher share of the profit which is made from their money.

In this regard, I am inclined to agree with the model of interest-free banks proposed by the earlier scholars. Instead of receiving deposits throughout a year, Siddiqi for instance proposed that the Islamic banks take the deposits at a specific time, i.e. quarterly (Siddiqi, 1983). The suggestion was made to distinguish one investment from another, so any potential profit could be distributed in a more accurate manner. However, this model does not attract the attention of Islamic bankers, presumably because it restricts the bank's opportunity to maximise its capital/fund. Open deposit taking is preferred and viewed as more practical because it would bring more funds to the Islamic bank as opposed to having a specific deposit time limit.

In addition to this, the argument regarding "depositors' consent" needs further clarification. An important question needs to be asked before one wishes to accept the argument: do depositors have negotiating power in determining profit distribution matters with the Islamic banks? In other words, do they have the choice not to give their consent? Based on the implementation of the *standard* *form contract*, the present practice seems to be a "take it or leave it" affair. The negotiating process as advocated by the classical jurists does not take place between the depositors and the Islamic banks. All decisions regarding the profit sharing ratio and the rate of return are made by the Islamic banks.

It is generally acknowledged that the *standard form contract* is the most practical given the context within which Islamic banks operate. Everyone seems to agree that it would be unrealistic to insist that the Islamic banks negotiate with every single depositor regarding the profit ratio. However, it is strongly felt that the rights of the depositors could be better taken care of by improving the level of transparency of Islamic banks' financial reporting. In the absence of the negotiating element, depositors need to be informed clearly pertaining to where their money has been invested and how much profit or loss has been made.

Although the implementation of the indicative rate of return is viewed as Sharīʿah compliance[4], I personally think it could mislead the true application of a *muḍārabah* contract. This is obvious when the Islamic banks regularly use the indicative rates as their advertisement technique in attracting new depositors. The matter seems no better because Islamic bankers while promoting the *muḍārabah* investment normally do not clearly explain the issue of "indication" unless specifically asked by a potential depositor. Hence, from my personal observation, the majority of the depositors commonly expect to receive the indicative rates of return from the Islamic banks. The indicative rates have led the general public to think that Islamic banks offer a guaranteed return on their investment. Such a perception clearly contradicts the underlying concept of a *muḍārabah* contract in particular and the objective of the establishment of Islamic banking institutions in general.

The practice of interim profit payment and the PER are undoubtedly controversial. They appear to contravene the principal rules of the *muḍārabah* contract as explained by the classical jurists. As discussed earlier, the classical jurists unanimously disallowed either the capital provider or the entrepreneur to take an accrued profit

---

4 Since it is just an "indication" and the profit which will be distributed depends on the actual profit made.

before the *muḍārabah* business was to be liquidated. They stressed that the profit distribution procedure was only completed when the capital was handed over to the *rabb ul-māl*. The justification of this rule was to avoid any ambiguity in the profit determination. Even if one of the contracting parties received the profit while the business was still in progress, he/she was obliged to return the profit in case the business suffered losses. Perhaps, the main reason why the Malaysian Islamic banks practice interim profit payment is to match the conventional banks' practices.

This replication policy was clearly seen when they introduced the PER. The practice of having a certain amount of profit as a reserve for a time of bad business is totally alien to the classical *muḍārabah* concept. To the best of my knowledge, none of the classical jurists had allowed such a practice. As argued by the Islamic banks, the PER was introduced to enable them to offer a stable and competitive rate of return to the depositors. Although the purpose of the PER is undeniably important, its implementation, however, causes more confusion. Let us consider an illustrative case as an example. Suppose a depositor puts his money in a *muḍārabah* general investment account for 3 months, commencing from January to March. During these months, the actual profit generated by the Islamic bank is relatively high. However due to the PER practice, some of the profit is taken as reserve for bad business times. What is the bank's justification in taking this action? The Islamic banks may argue that they obtain the depositor's permission based on the standard form signed at the beginning of the contract. But, as I highlighted earlier, the level of transparency pertaining to this matter is very low. The Islamic banks do not explain the PER mechanism clearly to the depositors.

Our preceding analysis indicates the replication approach adopted by the Malaysian Islamic bankers in performing "interest-free" bank activities. Having realised the difficulty in sticking with the classical rules of *muḍārabah*, they adopt the conventional practices in distributing profit to Islamic banks' depositors. This replication approach receives support from the local Sharīʿah scholars who uphold the pragmatic orientation.

VI. CONCLUSION

To conclude, the present practice of profit distribution in Malaysian Islamic banks is not without Sharīʿah issues. Given the sophisticated modern banking business, Islamic bankers and the Sharīʿah advisors face challenges in applying the classical theory of the *muḍārabah* contract. Some of their decisions appear to be contradicting the established rules founded by the classical jurists. The practice of the WM method is arguably not different from the conventional method which emphasises the duration of the investment rather than the investment activity itself. The indicative profit rate has led to public assumption that the Islamic banks also offer a fixed return on investment. The interim profit payment clearly contravenes the classical rules which disallowed profit distribution before liquidation of the *muḍārabah* business. Meanwhile, the PER policy brings injustice to some depositors. As a result of these practices, profit distribution matters have been exclusively controlled by the Islamic banks. The negotiation element which was always emphasised by the classical jurists does not take place. Furthermore, the level of transparency in providing adequate information to depositors regarding the profit earned is also far from satisfactory. Based on these findings, the present article indicates the replication and pragmatic orientations adopted by Malaysian Islamic bankers as well as their Sharīʿah advisors.

References

Ahmad, Norhayati & Haron, Sudin. (1998). The Existence of Conventional Banking Profitability Theories in The Islamic Banking System. *Journal Analisis,* School of Management University of Utara Malaysia. *5*(1& 2), 89-97.

Al-Bājī, ibn Khalaf, Sulayman. (1999). *Al-Muntaqā: Sharḥ Muwaṭṭa', vol. 7. Mālik*, Beirut: Dār al-Kutub al-ʿIlmiyyah.

Al-Dusūqī, Muḥammad ibn Aḥmad ibn ʿArafah. (n.d.). *Ḥāshiyat al-Dusūqī ʿalā al-Sharḥ al-Kabīr*, *ʿalā Mukhtaṣar Khalīl*) *li Aḥmad al-Dardīr maʿa taqrīrāt li Muḥammad ʿUllaysh.* , *vol. 3.* Cairo: ʿĪsā al-Bābī al-Ḥalabī.

Al-Nawawī, Yaḥyā ibn Sharaf. (1966). *Al-Majmūʿ*, *Sharḥ al-Muhadhdhab lil-Shīrāzī, vol. 14*. Cairo: Zakariyyā ʿAlī Yūsuf.

Al-Ṣadr, Muḥammad Bāqir. (1977). *Al-Bank al-lā Ribawī fī al-Islām*. Beirut: Dār al-Taʿāruf lil Maṭbūʿāt.

Al-Sarakhsī, Muḥammad b. Aḥmad. (1906).*Kitāb al-Mabsūṭ*, *vol.22*. Cairo: Maṭbaʿat al-Saʿādah.

Al-Sharbīnī, Muḥammad b. Muḥammad. (1958). *Mughnī al-Muḥtāj ilā Maʿrifat Alfāẓ al-Minhāj*, *vol. 2*. Cairo: Maṭbaʿat Muṣṭafā al-Bābī al-Ḥalabī.

Bank Islam Malaysia Berhad. (2007). *Mudarabah (Deposit) Contract Guidelines*. Kuala Lumpur. Prepared by Risk Management Division of BIMB.

Bank Negara Malaysia. (2004).*The Framework of Rate of Return*. Kuala Lumpur, http.//iimm.bnm.gov.my/view.php. Accessed on 29 October 2009.

Batcha, Obiyathullah Ismath. (2004). Dual Banking System and Interest Rate Risk for Islamic Banks. *The Journal of Accounting, Commerce and Finance: Islamic Perspective*, *1*, 1-42.

El-Tegani A. Aḥmed. (1996). Distribution of Profit in Islamic Banking: A Case Study of Faisal Islamic Bank of Sudan (FISB). *J.KAU: Islamic Econ., 8*, 15-32.

Hasan, Zubair. (2009). Islamic Banks: Profit Sharing, Equity, Leverage Lure and Credit Control, Forthcoming in *Symposium on Islamic Banking and Finance Melbourne University*, Australia.

Ibn Qudāmah, ʿAbd Allāh b. Aḥmad, Muwaffaq al-Dīn. (1999). *Al-Mughnī,* (4th ed.), *vol.7*. Beirut: Dār ʿĀlam al-Kutub.

Ismail, Abdul Ghafar & Shahimi, Shahida. (2006). *Profit Equalisation Reserve Decision: An Empirical Analysis of Islamic Banks in Malaysia*, Working Paper in Islamic Economics and Finance no. 0605, Bangi: National University of Malaysia.

Rosly, Saiful Azhar & Mohd Zaini,Mohammad Ashadi. (2008). Risk-return Analysis of Islamic Banks' Investment Deposit and Shareholders' Fund. *Journal of Managerial Finance*, *34*(10), 695-707.

Saḥ*n*ūn, ʿAbd al-Salām b. Saʿīd al-Tanūkhī. (1966). *Al-Mudawwanah al-Kubrā lil-Imām Mélik*, *vol. 5*. Baghdad: Maktabat al-Muthannā.

Siddiqi, Muḥammad Nejatullah. (1983). *Banking without Interest*, Leicester: The Islamic Foundation.

Udovitch, A.L. (1970). *Partnership and Profit in Medieval Islam*. Princeton: Princeton University Press.