

# Constraints in the Application of Partnerships in Islamic Banks: The Present Contributions and Future Directions

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## Abstract

*Partnership is considered as the essence of Islamic banking. Therefore, Islamic banks are supposed to rely on the partnership contracts for acceptance of deposits and investment of funds. In practice, Islamic banks adopt partnership contracts for accepting deposits. However, these are rarely used while investing. All over the world, Islamic banks rely heavily on non-partnership contracts for investment of funds. The present paper provides a critical review of the extant literature on the rare use of partnership contracts by Islamic banks for investment purposes. This review highlights the contributions that extant literature has made to the current knowledge about the constraints in the application of partnership contracts in Islamic banks. From this review, concentrations of research efforts are identified and directions for future research are proposed.*

*Keywords: constraints, partnership, contracts, Islamic bank.*

## 1. Introduction

The contracts of Islamic finance are based on two principles: Partnership and non-partnership (ElGindi, Said, & Salevurakis, 2009; Sundararajan & Errico, 2002). Partnership, commonly known as the profit and loss sharing (PLS) paradigm, allows a financial institution to earn profit on invested capital if the financial institution is willing to tolerate loss in case of the project failure (Aggarwal & Yousef, 2000; Bacha, 1997). The allocation of reward and risk to each partner, and the distribution of responsibilities among them are defined in the contract which is enforced by the social values and the ethical standards set in the *Shariah* (Hearn, Piesse, & Strange, 2012).

Contracts based on the partnership principle include *Musharakah* and *Mudarabah*. A *Musharakah* contract is a type of partnership where all partners jointly contribute capital and manage the business venture (Abdouli, 1991; ElGindi et al., 2009). Profits are shared based on a pre-negotiated ratio, while losses are borne in proportion to the capital contributed by the partners (Aggarwal & Yousef, 2000; Hearn et al.,

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2012; Kayed, 2012; Yousefi, McCormick, & Abizadeh, 1995). On the other hand a *Mudarabah* contract is a type of partnership between investor(s) (*Rabb al-mal*) and entrepreneur(s) (*Mudarib*), where the investor contributes capital while the entrepreneur employs labour and manages the venture (Abdouli, 1991; Aggarwal & Yousef, 2000). Profits are divided according to a pre-determined ratio, while the losses are exclusively borne by the investor.

The non-partnership contracts do not involve profit and loss sharing and entrepreneur usually has to pay a predetermined return. The non-partnership modes include *Ijara* (lease), *Murabahah* ('mark-up' or cost plus sale), *Bai Muajjal* (deferred payment), *Istisna'* (commission to manufacture), *Salam* (deferred delivery), *Qard Al Hasana* (charity loan) and *Jo'alah* (service fee) (El-Komi & Croson, 2013; Khan, 2010).

Advocates of Islamic banking concede that the partnership contracts are the ideal modes of financing and represent the true spirit of Islamic banking (Ahmad, 2000; Dusuki, 2007; Siddiqi, 1985). Therefore, partnership contracts should dominate the operations of Islamic banks. On the other hand, the non-partnership contracts should only be used where partnership contracts are not applicable (Khan, 2010; Usmani, 2007).

The present paper critically reviews the extant literature on the use of partnership contracts by Islamic banking institutions for investment purposes. The underlying objective of this review is to identify and synthesize constraints faced by Islamic banks in the application of partnership contracts for investment purposes. This discussion is developed further by providing certain suggestions for Islamic banking researchers regarding what could be researched further in order to develop a policy framework for these institutions to adopt partnership-based investment models more widely. Therefore, the present critique of literature is important for the consolidation of knowledge and development of research in this area.

Rest of the paper proceeds as follows: Section 2 and 3 shed light on the idealization of partnership contracts in Islamic banking and finance literature and its marginalization in the practices of Islamic banks respectively. Section 4 presents a review of the extant literature outlining the constraints in the application of partnership contracts. Section 5 presents a commentary on the opportunities that future researches can fruitfully pursue, Section 6 concludes the paper.

## 2. Partnership in Islamic Banking Literature

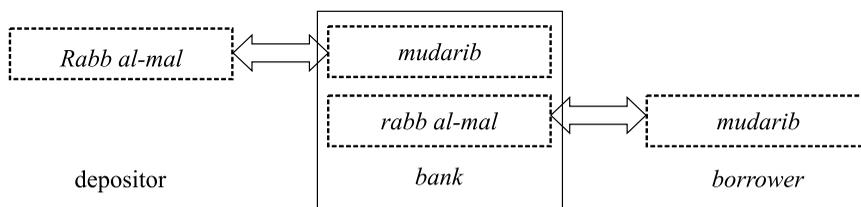
Partnership provides foundation for Islamic banking (Algaoud & Lewis, 2007; Ariff, 1988; Lewis, 2008; Zaher & Hassan, 2001). According to Gafoor (1995), the earliest references to the reorganization of banking system on the basis of partnership instead

of interest can be found in the pioneering work by Anwar Iqbal Qureshi, Mahmud Ahmad, and Naiem Siddiqi in late forties, followed by Abul A'ala Mawdudi in 1950.

Two pioneer Islamic economists including Anwar Iqbal Qureshi and Mahmud Ahmad proposed a banking system based on partnership (Shinsuke, 2012). Anwar Iqbal Qureshi in his book "Islam and the Theory of Interest" stated that interest is prohibited in Islam but partnership is not. In Islamic system there is no objection against a bank if it becomes partner with business ventures and shares profit and losses instead of giving them loans (Qureshi, 1946, pp. 158-159). His statement implies that the partnership-based financial contracts, i.e., *musharakah* and *mudarabah*, are more appropriate for the Islamic financial system (Shinsuke, 2012). Mahmud Ahmad, around the same time, mentioned his preference for partnership-based systems in his book. He stated that "the *Shirakat* banks would lend money to industry and commerce on the basis of *Shirakat*, that is, they would share the profit with their debtors rather than burden industry and commerce with a fixed rate of interest" (Ahmad, 1947, p. 170).

Siddiqi (1981) called the works of Anwar Iqbal Qureshi and Mahmud Ahmad pioneering in the literature of Islamic economics because most Islamic economists of the next generation followed their lead and encouraged partnership-based contracts as preferable instruments for Islamic finance (Shinsuke, 2012).

Muhammad Uzair and Muhammad Nejatullah Siddiqi, among the next generation scholars, made important contributions in developing a theory to make the proposed Islamic banking feasible in practice. In 1951, Uzair proposed the practical idea of *mudarabah*, which was later known as "two-tier *mudarabah*" (Uzair, 1978). According to Shinsuke (2012) the idea of Uzair was to use two *mudarabah* transactions in one scheme where depositors (*rabb al-mal*) would invest money with the bank (*mudarib*) on *mudarabah* basis, while bank (*rabb al-mal*) too would invest this money with the borrower (*mudarib*) on *mudarabah* basis. Thus the depositors (*rabb al-mal*) and the bank (*mudarib*) would conduct the first *mudarabah*, while the bank (*rabb al-mal*) and the borrower (*mudarib*) would conduct the second *mudarabah* (see Figure 1). Parties of the first *mudarabah* would share the bank's profit while those of the second *mudarabah* would share the borrower's profit.



Source Shinsuke (2012)

**Figure 1:** Mechanism of two-tier mudarabah

In 1969, Siddiqi contributed by developing a comprehensive picture of a *mudharabah*-based Islamic financial system. He not only elaborated the theory of two-tier *mudharabah*, but also expanded its application to the relationship between central bank and commercial banks (Siddiqi, 1983a).

Thus, it is evident that partnership has provided foundation for the Islamic banking system. The advocates of Islamic banking therefore claim that Islamic banks are supposed to act as suppliers of venture capital, financing promising ideas, and worthy ventures in exchange for share in the profits (Khan, 2010). Moreover, it is generally believed that the basic philosophy of Islamic banking cannot be translated into reality unless Islamic banks expand the use of partnership contracts (See for example, Sadique, 2012; Siddiqi, 1983b; Usmani, 2002, 2007).

The advocates of Islamic banking claim that partnership contracts are preferable to non-partnership contracts for several reasons: including their risk sharing features (Dar & Presley, 2000; Ebrahim & Safadi, 1995; Farooq, 2007). Partnership can play a vital role in gearing up economic stability and growth in several ways. First, promoting partnership in Islamic financial institutions (IFIs) will reduce the financial constraints faced by small and medium enterprises (SMEs) and new firms. Small and new firms hardly have any access to finances from traditional financial institutions because these firms often do not have enough acceptable physical collateral or track record to obtain finances from institutional sources (Berger & Udell, 1998). Partnership contracts of Islamic finance best suit the needs of such businesses as they provide Islamic bank an opportunity to share in the success of any enterprise without penalizing businesses unduly for any failure (Wilson, 2002). Therefore, promoting partnership in IFIs will elevate economic growth by supporting SMEs.

Second, partnership makes financiers participate in the risks of venture which induce them to assess the risks with utmost care and monitor the borrowers. The twofold assessment of investment proposals by both the borrower and the lender would help introduce greater health and stability into the financial sector (Chapra, 2002).

Third, according to ElGindi et al. (2009) only those projects are financed in the conventional system which are capable of repaying the principal amounts and interest. Therefore, other projects, in spite of their potential long-term profitability, might be ruled out. On the other hand in partnership based financing, projects are allocated solely on the basis of their potential productivity and profitability instead of their creditworthiness. Therefore, adopting a partnership system could increase the volume of investments, and thus increase worthwhile employment opportunities.

Fourth, according to Hicks (1982) interest has to be paid in both good and bad

times alike; whereas dividends can be reduced in bad times and can even be skipped in extreme situations. This factor should significantly reduce business failures, and in turn reduce, instead of promoting, economic instability.

Finally, partnership contracts ensure availability of more financial resources to small businesses and promote justice and equity in society since all deserving ventures get financed and not just the ventures with well-established credit history or excellent collateral (Khan, 2010). Therefore, most advocates of Islamic Banking hold that a financial system based on risk sharing would lead to greater allocative efficiency, equity, GDP growth, and financial system stability (Iqbal & Molyneux, 2005).

### 3. Partnerships in the Current Practices of Islamic Banks

Islamic banks adopt partnership contracts for the scheme of deposits, especially for term deposit accounts. However, contrary to the expectations of advocates of Islamic banking, Islamic banks do not adopt partnership contracts as the main investment scheme. Many scholars have pointed out this issue at various forums (See for example: Abou-Gabal, Khwaja, & Klinger, 2011; Aggarwal & Yousef, 2000; Ahmed, 2002; Amrani, 2012; Ariff, 1988; Bacha, 1995, 1997; Chong & Liu, 2009; Dar & Presley, 2000; Dusuki, 2007; El-Gamal, 2005; Farooq, 2007; Hanif & Iqbal, 2010; Hasan, 2002; Iqbal & Molyneux, 2005; Kayed, 2012; Khan, 2010; Lewis, 2008; Mirakhor & Zaidi, 2007; Sadique, 2010, 2012; Samad, Gardner, & Cook, 2005; Shinsuke, 2012; Siddiqi, 1983b, 1985, 2006; Usmani, 2007; Vahed & Vawda, 2008; Vogel & Hayes, 1998; Yousef, 2004; Zaher & Hassan, 2001). By far, the non-partnership contracts, especially *Murabahah* and *Ijara*, are the most dominant method for investing the funds.

Given the dominant reliance on non-partnership contracts, Islamic banking cannot be referred to as risk-sharing in any meaningful sense (Khan, 2010). The non-partnership contracts might be deemed satisfactory in fulfilling the requirements of *Shariah* compliance, but these are clearly insufficient to achieve the specific objectives of Islamic banking and the broader goals of *Shariah* (Kayed, 2012; Sadique, 2012; Siddiqi, 2006).

### 4. Constraints in the Application of Partnership Contracts

The strong and consistent tendency of Islamic financial institutions to rely on non-partnership contracts while lending results from necessity, not from preference (Bacha, 1995; Karim, 2002). *Musharakah* and *Mudarabah* have serious practical problems (Sumarti, Fitriyani, & Damayanti, 2014). To avoid the problems in partnership contracts Islamic banks rely mainly on non-partnership contracts while investing funds. Therefore, to promote partnership it is necessary to first identify the underlying

problems of partnership contracts and the constraints faced by Islamic banks in the application of these contracts.

Many authors have provided different explanations for the under-utilization of the partnership contracts. However, literature remains scattered with diverse studies focused on different dimensions of the issue. Therefore to produce a coherent view, major constraints outlined in the extant literature have been consolidated. Table 1 summarizes factors hindering the application of *Musharakah* and *Mudarabah* modes of financing in the view of different researchers.

**Table 1.** Constraints in the application of partnership contracts

CONTRIBUTORS	CONSTRAINTS
Ascarya (2010); Ascarya and Yumanita (2006); Sadique (2012)	Upper management of Islamic banks is not committed and sincere in devising workable alternatives based on partnership.
Akacem and Gilliam (2002); Khan (1995); Sadique (2010, 2012); Samad et al. (2005)	Lack of skilful human resource.
Abou-Gabal et al. (2011); Boumediene (2011); Hasan (2002); Vahed and Vawda (2008)	Higher risk
Dar, Harvey, and Presley (1999); Dar and Presley (2000); Farooq (2007); Samad et al. (2005)	Lack of applicability
Khan (1995); Sadique (2012)	More complicated to structure and deal with partnership contracts.
Samad et al. (2005); Usmani (2002)	Partnership contracts may disclose the secrets of the business to the financier and other parties
Hanif and Iqbal (2010); Khan (1989); Siddiqi (1991)	Low levels of reliability and trustworthiness in the market
Dar et al. (1999); Dar and Presley (2000); Khan (2010)	Lack of properly defined or protected property rights in Muslim countries
I.C.M.T Force (2004); Khan (1995); Naughton and Naughton (2000); Solé (2007); Zaher and Hassan (2001)	Absence of a supportive regulatory and legal framework
Abou-Gabal et al. (2011); Archer, Karim, and Al-Deehani (1998)	Low quality and quantity of accounting information
Iqbal (1997); Khan (1995); Naughton and Naughton (2000); Zaher and Hassan (2001)	Illiquid and shallow secondary market for Islamic financial instruments
Dar and Presley (2000) Dar et al. (1999); Sadique (2010)	Unfair treatment in taxation and Tax evasion
Chong and Liu (2009); Dar et al. (1999); Dar and Presley (2000); Hanif and Iqbal (2010); Khan (1995); Pryor (2007); Samad et al. (2005)	Severe competition from conventional banks and other financial institutions.
Ascarya (2010); Ascarya and Yumanita (2006)	Lack of commitment and support from government

Naughton and Naughton (2000); Siddiqi (1991); Solé (2007); Zaher and Hassan (2001)	Lack of sound accounting procedures and standards consistent with the Islamic laws
Ascarya (2010); Ascarya and Yumanita (2006); I.C.M.T Force (2004)	Lack of understanding and knowledge among society regarding the fundamentals of the Islamic finance and banking
Hanif and Iqbal (2010); Khan (1989); Siddiqi (1991)	Low levels of reliability and trustworthiness in the market
Ascarya (2010); Ascarya and Yumanita (2006)	Low demand for PLS financing
Adnan and Muhamad (2008); Aggarwal and Yousef (2000); Akacem and Gilliam (2002); Al-Suwailem (1998); Amrani (2012); Archer et al. (1998); Ascarya (2010); Ascarya and Yumanita (2006); Bacha (1997); Bashir (1996); Chong and Liu (2009); Dar et al. (1999); Dar and Presley (2000); Farooq (2007); Hasan (2002); Kayed (2012); Khan (1995); Khan and Ahmed (2001); Mirakhor and Zaidi (2007); Sadique (2012); Samad et al. (2005); Sarker (1999); Siddiqi (1983b, 2006); Sundararajan and Errico (2002)	Agency problem
Adnan and Muhamad (2008); Aggarwal and Yousef (2000); Ahmed (2002); Al-Suwailem (1998); Archer et al. (1998); Ascarya (2010); Ascarya and Yumanita (2006); Bashir (1996); El-Din (2008); Farooq (2007); Hasan (2002); Khan (2010); Khan (1995); Khan (1989); Sadique (2010); Sarker (1999); Sundararajan and Errico (2002)	Asymmetric information
Aggarwal and Yousef (2000); Al-Suwailem (1998); Archer et al. (1998); Ascarya (2010); Ascarya and Yumanita (2006); Bashir (1996); El-Gamal (2005); Khan (2010); Khan (1995); Khan and Ahmed (2001); Pryor (2007); Sarker (1999); Siddiqi (1983b, 2006)	Adverse selection
Abou-Gabal et al. (2011); Adnan and Muhamad (2008); Aggarwal and Yousef (2000); Ahmed (2002); Amrani (2012); Ascarya (2010); Ascarya and Yumanita (2006); Bacha (1997); Bashir (1996); Chong and Liu (2009); Dar et al. (1999); Dar and Presley (2000); Dees (1992); El-Din (2008); El-Gamal (2005); Farooq (2007); Khan (2010); Khan (1995); Khan and Ahmed (2001); Khan (1989); Kuran (1995); Pryor (2007); Rethel (2011); Sarker (1999); Sen (1987); Siddiqi (1983b); Solé (2007); Sundararajan and Errico (2002); Usmani (2002); Wolozin (2002); Zaher and Hassan (2001)	Moral hazards
Akacem and Gilliam (2002); Chong and Liu (2009); Khan (1989); Mirakhor and Zaidi (2007)	Higher monitoring costs
Ascarya (2010); Ascarya and Yumanita (2006)	Risk averse depositors

The extant literature indicates that the asymmetric information, adverse selection, moral hazards and agency problems in partnership contract are the dominant constraints. Asymmetric information is a situation that arises when insufficient knowledge of one party about the other one involved in a transaction makes it impossible to take accurate decisions while conducting that transaction (Mishkin & Eakins, 2011). Since partnership contracts are formulated in the form of principal-agent arrangements (Bashir, 1996), these are prone to the asymmetric information problem. The agent (an entrepreneur who seeks funds) being an insider party has better knowledge about the project he/she wishes to undertake; whereas the principal (a bank which provides the funding needed to initiate the project) being an outsider party usually has less knowledge about potential returns and the associated risks of the project than the agent does (Khalil, Rickwood, & Murinde, 2002). This asymmetric information creates problems in the partnership arrangements on two fronts, i.e. before the project is initiated (adverse selection), and after it has started (moral hazards).

Adverse selection is the problem of lending money to inappropriate applicants. It is faced due to asymmetric information before occurrence of the transaction (Mishkin & Eakins, 2011). Borrowers have better inside information about themselves (including their abilities and intentions) and project (including its potential returns and likelihood of success), but they may not credibly signal it to the bank in the wake of exploiting interest of bank for their own benefits (Iqbal & Molyneux, 2005; Sarker, 1999). Since it is difficult for banks to determine the quality of a loan applicant, this creates adverse selection problems (Mills & Presley, 1999) because it is more likely that funds might be lent to inappropriate applicants. To control the adverse selection problem bank has to appraise the projects with utmost care.

On the other hand, moral hazard (ex-post asymmetric information) is the problem faced due to asymmetric information after a project is initiated (Mishkin & Eakins, 2011). Moral hazard in partnership arrangements is the risk (hazard) that borrower might involve in activities that are undesirable (immoral) from the bank's point of view. These problems are associated with under reporting or artificial reduction of the actual profit and the difficulty of observing the entrepreneur's actions (Amrani, 2012). The Islamic bank would therefore need to incur costly monitoring expenses to ensure that the behaviour of entrepreneur is consistent with the bank's interests.

The adverse selection and moral hazard problems induce high risk of default in partnership arrangement. Moreover, the additional dead weight costs in pre-contract project appraisal and post-contract monitoring to control these risks make partnership agreements more costly (Sarker, 1999). Therefore the inherent high risk and additional costs make partnership contracts less attractive for Islamic banks.

## 5. The Present Contributions and Future Directions

The extant literature outlines different reasons for marginalization of partnership contracts by Islamic banks. However, an important limitation of this literature is its overwhelming focus on the academia's view point, i.e., it presents the view point of academia regarding constraints in the application of partnership contracts (See for example Bacha, 1995, 1997; Bashir, 1996; Dar & Presley, 2000; Farooq, 2007; Kayed, 2012; Khan, 2010; Samad et al., 2005) but the practitioners' view point remains relatively ignored. There is a lack of researches which could provide the viewpoint of practitioners on the problem of rare utilization of partnership contracts. Although a limited number of studies in the extant literature investigate the practitioners' view point using survey strategy (See for example Ahmed, 2008; Ajija, Annisa, & Hudaifah, 2012; Ascarya, 2010; Farooq & Ahmed, 2013; Hanif & Iqbal, 2010; Khalil et al., 2002); however these studies have the following limitations:

First, according to Yin (2003), "the survey designer, constantly struggles to limit the number of variables to be analyzed (and hence the number of questions that can be asked) to fall safely within the number of respondents that can be surveyed" (p. 13). The same problem prevails in the mentioned studies. Table 1 indicates that the extant literature highlights a large set of factors restraining the application of partnership contracts. However, these studies investigate a limited number of factors. Table 2 reports the number of constraints being investigated in the mentioned survey based studies.

**Table 2:** Number of constraints investigated in the survey based studies

Studies	No. of constraints being investigated *
Khalil et al. (2002)	9
Ahmed (2008)	4
Ascarya (2010)	14
Hanif and Iqbal (2010)	7
Ajija et al. (2012)	10
Farooq and Ahmed (2013)	11

\* The overlapping factors have been either eliminated or combined

Second, survey is not a suitable strategy if researcher wants to investigate, in depth, a contemporary phenomenon within its real life context because it has got an extremely limited capability to examine the context (Yin, 2003).

To extend our understanding of constraints in the application of partnership contracts beyond the prevailing explanations offered in the extant literature, future

studies should more rigorously investigate the practitioners view point. Future studies should use methods other than survey including case study and grounded theory methodology since these methods are more flexible and enable researchers to explain the problem within its real life context. In a nut shell, need is felt for strong theory-building studies which could present deep insights about the problem at hand.

## 6. Conclusion

Partnership is the essence of Islamic banking and finance and represents the true spirit of an Islamic banking system. However, in practice Islamic banks tend to avoid partnership while investing. They rely heavily on the *Shariah* compliant non-partnership contracts for investing the funds. The strong and consistent tendency of Islamic banks to rely on non-partnership contracts has provided grounds for raising serious questions on the legitimacy of Islamic banks and their ability to meet the specific objectives of Islamic banking and the broader goals of the *Shariah*.

Islamic banks rely on non-partnership contracts for investment purposes because the partnership contracts have serious practical problems. Many researchers have provided different explanations for marginal utilization of partnership contracts by Islamic banks for investment purposes. Review of the extant literature indicates that asymmetric information, adverse selection, moral hazards, and agency problems in partnership contracts are the dominant constraints.

An important concentration apparent within the extant literature is the overwhelming attention given to academia's view point for explaining the tendency of Islamic banks to avoid partnership contracts; whereas the practitioners' viewpoint remain relatively unexplored. Therefore, future studies should investigate the practitioners view point more rigorously. In short, the problem of marginalization of partnership by Islamic banks needs creative reframing into a new theoretical vision that could provide deep insight about the problem. This will help in identification and better understanding of the factors that hinder the implementation of partnership contracts. Moreover, it would facilitate Islamic financial institutions, government, and regulatory authorities in policy implications to make the partnership contracts an attractive option. In short, these studies would act as a step towards economic growth and stability by playing major role in the promotion of partnership paradigm and helping Islamic banking in achieving its basic philosophy of being Islamic.

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