NUST JOURNAL OF SOCIAL SCIENCES AND HUMANITIES
Vol.5 No.1 (January-June 2019) pp. 43-62

The Current Model of Islamic Banking and Concentration of Wealth

Waqasul Hassan* and Anwar Shah†

Abstract:

The eradication of the concentration of wealth is one of the prime objectives of Islamic finance. Many scholars have written on this issue, who claim that by eradicating interest from the society, we will be able to minimise the concentration of wealth in an economy. This study conjectures that interest-free finance is a necessary but not sufficient condition for the eradication of concentration of wealth. The sufficient condition is to bring change in the objective of the Islamic banks that is, switching the moto from the maximisation of the profit to the maximisation of welfare of society. This paper states that the main focus of Islamic banks is to transform the current models of interest based transactions to interest free transactions. However, merely changing the transactions from interest based to interest free might not be enough to achieve the main objective of Islamic finance. The study compares the assets side of Islamic and conventional banks to provide support in favour of the hypothesis that with current objective of profit maximisation, the Islamic banks are less likely to play any role in the eradication of the concentration of wealth.

***Keywords*:** Circulation of Wealth, Islamic Finance, Participatory finance, Interest rate.

1. INTRODUCTION

Wealth plays a key role in the development of an economy. However, it is not the production of wealth that matters; it is the circulation of wealth that is important for an economy. For this purpose, conventional economics has developed a financial system to ensure the circulation of wealth within an economy [Mishkin (2004)]. The main objective of such financial system is to ensure the channelisation of money from surplus unit (savers) to deficit units (Investors). Such channelisation takes place either directly through money and capital markets or indirectly through financial intermediaries such as banks etc.

---

* Waqasul Hassan <waqas.hassan92@hotmail.com> is Graduate, School of Economics, Quaid-i-Azam University, Islamabad, Pakistan.

† Anwar Shah <anwar@qau.edu.pk.> is Assistant Professor, School of Economics, Quaid-i-Azam University, Islamabad, Pakistan.

The main lubricant for the flow of money from the surplus unit to the deficit unit in the conventional financial system is interest. Banks pay interest to depositors and receive interest from investors. One of the main outcomes of interest based financial system is the concentration of wealth in economies. The reason is that funds are not allocated on the basis of productivity in economy; rather it is allocated on the basis of credit worthiness. Hence, large corporations and businesses enjoy access to funds and earn billions. New but productive investors are denied access as they do not have collaterals. Thus, interest based financial system is structurally flawed to solve the issue of the concentration of wealth.

Is there any solution of this issue of the concentration of wealth? The answer is yes provided that interest is declared illegal. In this regard, economic system based on the tenants of Islam provides an ideal solution for the problem of concentration of wealth. First, Islam declares interest illegal.[1]

Next, Islam provides a comprehensive alternative for the flow of money from savers to investors without interest. These alternatives are in the form of three main modes of financing. The first alternative is trade based and includes "*Murabaha*" "*Bai Salam"* and "*Bai Moajjal".* The second alternative is leasing based, mainly including "*Ijara*" and the third alternative is participatory based, that includes "*Mudharabah*" and "*Musharkah*".

Based on the tenets of Islam, a large industry has emerged in the world in general and Islamic countries in particular to provide Islamic finance in the market. Pakistan has also initiated Islamic finance since 1979 and was among the first three countries with interest free banking. However, the system could not move successfully due to lack of sharia guided rules, proper homework at the level of central bank and

[1] The Holy Quran in four different places (surah) mentions the prohibition of interest (Riba). *Surah Al-Rum, verse 39, Surah Al-Nisa', verse 161, Surah Al 'Imran**, verses** 130-32 and Surah al-Baqarah, verses 275-81.* Likewise, different sayings of the Holy Prophet Muhammad (PBUH) mention the prohibition of interest: For example, as Hazrat Jabir (RA) states that The Prophet (PBUH) cursed the receiver and the payer of interest; the one who records it and witnesses of the transaction and said: "They are all alike [in guilt].

unacceptability of sudden shifts for banks from conventional to Islamic modes.[2]

Hence, Islamic banking was re-launched in Pakistan in 2001 after removing the above mentioned deficiencies by the Government of Pakistan. For this purpose, Islamic banking department in State Bank of Pakistan (SBP) was established in 2003. This department aims to enhance and strengthen sharia compliance finance in Islamic Banks. Over time, five full-fledged Islamic banks and fourteen conventional banks with Islamic banking branches started operating in Pakistan.[3]

It is pertinent to mention that the main mode to ensure the circulation of wealth in Islam is participatory based financing that is "*Mudharabah*" and "*Musharkah"*. The reason is that it leads to efficiency as well as equity, simultaneously. Efficiency comes as in participatory financing funds transfer from one person to another based on productivity and not on the basis of creditworthiness leading to increase in the level of production of wealth. Equity comes as both parties distribute profit according to the predetermined agreed ratio. Moreover, in case of loss both bear the loss and economy is relieved from passing the responsibility to other people in society. Nevertheless, Islamic finance industry prefers sale based transaction and that too "*Murabaha"* instead of doing participatory based financing. The data show that the share of *Mudharabah* has decreased while that of the share of *Murabaha* has increased over time in the Islamic banking industry within Pakistan and across the world (see for example, Islamic Banking Bulletin by State Bank of Pakistan). Hence, one can claim safely that Islamic banks are playing very passive role in minimizing the concentration of wealth within an economy.

Why is this the case? Some scholars have highlighted the reasons that why Islamic banks is not playing a role in minimizing the concentration of wealth. For example, Razi (2014) reports that the lack

---

[2] State Bank of Pakistan (http://www.sbp.org.pk/departments/ibd.htm).

[3] List of full-fledged Islamic Banks are: Meezan bank, Al Barakah Islamic Bank, Bank Islamic, Dubai Islamic bank and Burj Bank limited. While the list of banks with Islamic braches are: Habib Bank, Askari Bank, National Bank of Pakistan, Muslim Commercial Bank, United Bank Limited, Bank Al-Habib, Dawood Islamic Bank Limited, Standard Chartered Bank, Emirates Global Islamic Bank, Bank Al-Falah., Summit Bank, Bank AL-Habib Limited, The Bank of Khebar.

of regulations for Islamic banking in Muslim countries is playing a role in the concentration of wealth. Dar and Presely (2000) show that agency problem, lack of property rights, and tough competition from conventional banks determine this failure. Abdul and Sarker (1999) considers the issue of principle agent as the major cause of the low level of participatory financing. However, to our knowledge researchers have given little attention to the motive of profit maximization of banks as one of the possible factors in the concentration of wealth. In this paper we aim to fill this research gap.

This study adds in the current literature in the sense that the motive of profit maximisation in Islamic banks herself is the main reason for the concentration of wealth. We are of the view that Islamic finance industry has entered the market with the objective of profit maximisation. Hence, there is no difference in the objective of conventional and Islamic banks. The only difference is that conventional industry does not take into account the compatibility of any modes with Islamic teaching while the latter tries to give due regard to Islamic teachings. However, Islamic banks are making pick-and-choose policy in the available modes of Islamic financing and mostly choose the one with the high probability of profit and low level of risk. Therefore, they mostly pick sale-based financing and leave participatory-based financing.

In order to pursue the motive of profit maximisation on average each Islamic bank tries to make contract with financially sound and strong organizations. They are ready to enter into participatory financing with such organisations. But the profit motive of such organisations requires to avoid sharing profit with Islamic Banks. So they prefer fixed return-based financing. On the other hand, the profit motive of financially weak organization requires that they should enter into participatory-based financing with Islamic banks but the profit motive of Islamic Banks requires to enter into low risk sale- based transaction with them. Hence, the profit motives of Islamic Banks do not allow them to minimise the concentration of wealth. In this paper we set out to test whether such outcomes of profit motives is supported by data. In other words we want to know whether sound organisations/firms prefer fixed return-based financing while weak organisations/firms prefer participatory-based financing.

To test our hypothesis, we collect data from firms in Pakistan. We collect data regarding assets and profit after tax from the annual reports of firms. While, information regarding willingness for taking partnership or sale-based finance from Islamic banks is collected through telephone. We mainly test that the firms with higher level of profits will prefer non-participatory based financing with Islamic banks. On the other hand, firms with low level of profits will prefer participatory-based financing with Islamic banks. However, the data we collected partially support this hypothesis. We find that large corporations are willing to enter into participatory-based financing with Islamic banks. The probable reason, we found, on the basis of our telephonic interview is that Islamic banks offer high share in the profit to them. The study suggests that Islamic banks can engage large corporations only if it sacrifices some fraction of its profit. The limitation of the study is that we could not test the hypothesis for small corporations and businesses. We divide the registered companies on the basis of profit level into large and small, which is not a very objective criterion for dividing the firms into strong and weak. Future research can test our hypothesis with rich data.

The rest of the paper is organized as follows: Section 2 discusses literature review. Section 3 describes theoretical framework and hypotheses. Section 4 explains data and model, Section 5 discusses results, while Section 6 concludes the study.

2. LITERATURE REVIEW

In this section, first we present literature that discusses the reason of trade-based finance in Islamic banks industry on theoretical basis. Then, we present some empirical studies, which examine factors affecting the behaviour of players in Islamic banks industry.

2.1. Theoretical Literature

Interest-bearing system promotes income inequalities and has detrimental effects on efficiency and growth [Siddiqui, (2004)]. Likewise, it disturbs balance in the society, creates political issues, and paves way for many extremist theories [Chapra (2008)]. On the other hand profit and loss sharing financial system brings efficiency and equity in the society. However, Islamic banks rarely follow the modes of profit loss sharing (PLS). This is inspite of the fact that the pioneers of Islamic bank clearly mention that the main objective of Islamic banks is to provide the opportunity of participatory mode of financing to clients [See for details, Moudoodi (2000), (2002)] What are the reasons of this theoretical drift? Mughal (2017) provides a comprehensive detail about such drift. He mentions that over time some scholars start considering PLS and trade-based financing to be the same. While the pioneers used to considered participatory finance to be the best and allowed the trade-based finance in special circumstances, but over the time scholars provide justification for combining several contracts in one contract to justify sharia issues in the *Murabaha*-based finance. In the same manner Islamic scholars start defending all types of criticism on sale-based financing [see for example, Ismail (1986), (2001); El-Gamal (2000) for theoretical justification of sale-based financing]. Hamoud (1982) also highlights the constraints of participatory financing in the Islamic banking industry. Haque (1985) provides details on how participatory financing may provide benefit to one person in case of asymmetric information. In the same line, Warde (2006) sheds light on the issue of adverse selection and moral hazard in the participatory mode of financing. Saeedi (1998) and Usmani (2009) provide justification of joining more contracts into one contract. The loan created after sale-based products are paid in installments and assumed tantamount to interest. However, they are justified on the basis that though such modes do not equal the ideal of PLS system, yet they serve the needs of real economy without involving the volatility of conventional interest-based system because they are based on the sale of real asset [Nienhaus, (2011)].

Dar and Presely (2000) consider agency problem as one of the factors for lack of profit and loss sharing in Islamic banking. Likewise, weak property right in Islamic countries, tough competition from conventional banks, restrictive role of investor in management, unfair treatment with PLS in taxation and imbalance in management and control in PLS are some of the reasons of low level of participatory financing in Islamic banks. Abdul and Sarker (1999) also consider principle agent problem as the major cause of low level of profit loss sharing finance in Islamic banking. They mention that it is very difficult for Islamic banks to get true information about borrowers. In the same way, the issue of moral hazard and adverse selection restrict Islamic banks to compete with conventional banks.

2.2. Empirical Literature

Kasri and Kassim (2009) provide details regarding how deposits flow of Islamic banks are influenced by the return on deposits in conventional banks. They examine the factors that determine saving in Islamic banks of Indonesia using data from 2000 to 2007. The study shows that when real rate of return provided by Islamic banks is lower than the real interest rate provided by conventional banks then people transfer their funds from Islamic banks to conventional banks. Rachmawati and Syamsulhakim (2004) also explore the factors responsible for investment in Mudharabah deposits in Indonesia using Quarterly data from 1993 to 2003. The study takes the variables of GDP, profit sharing ratio, interest rate, number of branches of Islamic banks, and Mudharabah deposits for the purpose of analysis. Cointegration technique is used to find out long-run relationship between investment in Mudharabah and other factors. The findings show that the number of branches of Islamic banks significantly affects Mudharabah deposits in Islamic banks, while interest rate and GDP do not have significant effect.

Jaffar and Musa (2014) examine the demand of Islamic financing from halal industry in Malaysia. The findings show that 40% halal industry were currently using Islamic finance while 60% were non-users. The reason of the non-user was the absence of knowledge about Islamic finance. The study shows that 40% respondents had knowledge of Islamic finance, 10% had partial knowledge while 50% had limited to zero knowledge about Islamic finance.

To our knowledge, we did not find empirical work that relates the motive of profit maximisation with the trend of non-PLS transaction in Islamic banks. Hence, this paper is an effort in this direction. We examine whether profit maximisation is one of the main motives of low level of participatory financing. We examine this issue from demand side; i.e., from the actual financial contract of firms with Islamic banks.

3. THEORETICAL FRAMEWORK AND HYPOTHESIS

Profit maximization is the main assumption for theories related to firms in Economics. In addition, such behavior of firms is considered important for the allocative efficiency of funds in the market. In this regard the following quote of Adam Smith (1776) is widely referred.

> *"It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities, but of their advantages" (Book 1, Chapter 2 Page 2).*

Contrary to the above, this study assumes that the objective of profit maximisation leads to inefficiency in the financial market in the form of concentration of wealth in an economy. We are of the view that if firms including Islamic banks pursue profit maximisation in the market, then the concentration of wealth is inevitable. The contract based on non-participatory finance with clients symbolizes such a situation. We explain such an outcome in game theoretic form in Table 1. The table presents normal form of a battle of sexes game with two players. Player 1 is strong firm while player 2 is Islamic bank. Player 1 prefers the strategy of Non-PLS, while Islamic bank prefers the strategy of PLS. It is to be noted that PLS stands for profit-loss sharing contract.

Table 1. Game Theoretic Presentation of the Interaction of Islamic Banks with Strong Firms

		Player 2 (Islamic bank)	
		PLS	Non-PLS
Player 1 (Strong firm)	PLS	Low, High	Zero, Zero
	Non-PLS	Zero, Zero	High, Low

The game has two Nash Equilibria. However, theory fails to predict which Nash Equilibrium will prevail. Nevertheless, behavioural game theory [Camerer (2003)] suggests that Nash Equilibrium of (Non-PLS, Non-PLS) will prevail as Islamic banks cannot afford to disappoint strong firms in the market. They fear that if we will not accept the demand of strong firms, we might lose a strong customer, which will transmit negative signals in the markets for other customers and a profit maximizer firm cannot afford such negative signals in the market.

If we replace player 1 with a weak firm as shown in Table 2, then Islamic banks are not interested in PLS with such firms. The banks consider PLS risky with such firms. On the other hand, such firms prefer PLS with Islamic banks as they think that in case of loss, the banks will bear all the risk. In such circumstances, the Nash Equilibrium will be again (Non-PLS, Non-PLS). Here bargaining position of the bank is strong; hence, its dominant strategy will prevail.

What is the upshot of these two tables? The upshot is that in a market where profit maximisation is the motive of Islamic Banks, they will prefer PLS with strong firms, but such firms would not like to share their profit with Islamic Banks. So the outcome will be No-PLS contract. Conversely, weak firms would like PLS with Islamic Banks, but the banks do not want so. Hence, in both situations, there will be non-PLS equilibrium. Hence, the level of concentration of wealth will not drop even in the case of Islamic Banks in financial industry. Based on the above discussion, we make two hypotheses.

Hypothesis 1: *Financially sound Profit maximiser firms are less likely to demand PLS contract from Islamic Banks.*

Hypothesis 2: *Islamic banks are less likely to offer PLS to financially weak firms.*

Table 2. Game Theoretic Presentation of the Interaction of Islamic Banks with Weak Firms

		Player 2 (Islamic Bank)	
	Modes	PLS	Non-PLS
Player 1 (Weak firm)	PLS	High, Low	Zero, Zero
	Non-PLS	Zero, Zero	Low, High

4. DATA, VARAIABLES, AND MODEL

To test the hypotheses of the study, we collect data on assets and profits of the firms in Pakistan. Assets of a firm include current (stock in investment, short term investment) and non-current assets (plant, property, equipment). This is collected from annual financial statements of firms for 2010 to 2013. Profit of a firm includes profit after taxation. This is also collected from annual financial statements of firms. We categorize firms into two types: strong and weak. If a firm has average profit equal or greater than the average of the industry's profit, we termed it strong otherwise weak.[4] The key variable to test our hypotheses is the status of current contract between firms and Islamic Banks. This information is not available through secondary data sources. Hence, we tried to collect this information through email, but response was very poor and negligible. Thus, we collected this information through telephone calls. For this, first, we collect landline numbers of firms from their website. Next, we contact on phone with CFO (chief financial officer) of the firm. In case he/she was out of contact, we then contacted any senior most employees in the finance section of firms. Through this process, we collected data from 100 firms. After brief introduction regarding our research work and university, the main question we asked on phone was: *"Has your company ever taken Mudharabah or Musharakah (Partnership based Islamic) financing from banks (Islamic)*

[4] This categorization is subjective, we tried to get a cut-off point from literature, but we could not get any reference. To make the categorization objective we took the average profit of industry as cut off line. Firms above such line are strong and firms below such line are weak.

within last 5 years?[5]*"*. Positive reply of the question was record as 1 otherwise zero.

We want to examine the role of the size of assets and profits on the decision of firms regarding participatory financing with Islamic Banks. Hence, dependent variable of the study is whether a firm opts for participatory financing or not. This is captured through a dummy variable, which takes the value of 1 for the participatory contract with Islamic Banks, otherwise zero. Hence, the dependent variable is binary for which the relevant model is Logit model as shown below:

$$L_i = \ln\left(\frac{P_i}{1-P_i}\right) = Z_i = = \alpha + \beta_1(\text{Average asset of firm}) + \beta_2(\text{Average profit after tax}) + \mu \qquad \ldots (1)$$

where L stands for logit, p is probability of getting PLS facility and 1-p is probability of not getting PLS facility.

5. RESULTS

5.1. Overview of the Islamic Products in Pakistan

Table 3 provides comparison of various types of financing in the Islamic Banking industry of Pakistan. The table shows the volume of trading, Ijara, and participation based financing for the period of 2012 to 2015. The comparison of the data in Table 3 is in line with the hypothesis of this study that the motive of profit maximisation leads to non-PLS contracts in the Islamic banking industry. We observe that the share of Mudharabah financing decreases over time. However, the share of Musharkah is increasing over time, which is not in line with our hypothesis. One can ask why the share of Musharakah is increasing over time as compared to Mudharabah? A probable answer is that the level of risk in Musharakah as compared to Mudharabah is lower for Islamic banks. In Musharakah both share capital, hence both (the banks and investor) share the profit as well as the risk of loss. Though increase in

[5] Question is asked about last 5 years just to make it compatible with average of data.

the share of Musharakah is appreciable but is less likely to increase the circulation of wealth.

Table 3. Comparison of Modes of Financing in Islamic Banking Industry in Pakistan (in billion Rupees)

Modes of Financing	Dec-12	Sep-13	Dec-13	Sep-14	Dec-14	Mar-15	Total
Murabaha	97.5 (39.7%)	112.5 (40.2%)	134.2 (40.6%)	105.7 (30.3%)	127.2 (30.1%)	113.7 (27.09%)	690.8 (33.7%)
Ijarah	22.5 (9.2%)	24.2 (8.6%)	25.4 (7.7%)	29.8 (8.6%)	32.3 (7.7%)	33.1 (7.9%)	167.3 (8.1%)
Musharakah	1.9 (0.8%)	11.6 (4.2%)	22 (6.7%)	35.0 (10.1%)	46.5 (11.0%)	47.6 (11.4%)	164.6 (8 %)
Mudharabah	0.6 (0.2%)	0.5 (0.2%)	0.5 (0.2%)	0.5 (0.2%)	0.2 (0.1%)	0.2 (.04%)	2.5 (0.12%)
Diminishing Musharakah (DM)	87.7 (35.7%)	92.6 (33%)	101.8 (30.8%)	122.5 (35.1%)	137.7 (32.6%)	147.9 (35.9%)	690.2 (33.7%)
Salam	7.3 (3%)	9.5 (3.4%)	13.3 (4 %)	9.0 (2.6%)	19.2 (4.5%)	22.3 (5.3%)	80.6 (3.9%)
Istisna	17.7 (7.2%)	13.4 (4.8%)	18.5 (5.6%)	27.5 (7.9%)	35.2 (8.3%)	31.0 (7.4%)	143.3 (7%)
Others	10.5 (4.3%)	15.7 (5.6%)	14.5 (4.4%)	18.4 (5.3%)	23.8 (5.6%)	21.9 (5.2 %)	104.8 (5.1%)
Total	245.7	280.1	330.2	348.5	422.1	417.8	2044.4

Source: Bulletin from Islamic banking department of state bank of Pakistan.

The reason is that the role of Musharakah in decreasing the concentration of wealth in the hands of few is lower than the role of Mudharabah. On the other hand, the magnitude of Murabaha is far greater than the magnitude of Mudharabah, and Musharkah. In other words, the share of Musharakah as compared to Murabaha is very low.

5.2 Descriptive Statistics

We provide detail regarding ratio of PLS financing in Table 4. The table shows that 37 out of 100 firms are taking funds from Islamic banks on the basis of PLS. However, we find very weak support in favour of our hypothesis that financially strong firm have non-PLS contract with Islamic bank. Per data 18/37 (48%) strong firms are doing PLS with Islamic banks. While 19/37 (52%) are doing non-PLS with Islamic Banks. What might be the reason of this contradictory result? One of the probable reasons could be the subjective division of firms between strong and weak on the basis of annual average profit. It is possible that whom we consider weak might be strong firms and vice versa. Hence, we cautiously state that our hypothesis is rejected based on the collected data

Table 4. Participatory Financing and the Types of Firms

	Total	Number of Strong firm[6]	Number of non-strong firms
Number of firm	100	27	73
Firms with PLS financing	37	18 (48%)	19 (52%)
Firms with Non-PLS financing	63	9 (15%)	54 (85%)

We also find that 63/100 firms are doing non-PLS financing with Islamic Banks. It is worth mentioning that the average profit of only 9/63 (10%) is more than one thousand million rupees (average profit of the industry). That is only 9 firms are strong based on the criterion we have defined. While the average profits of 11/63 (18%) is higher than five hundred million rupees while the average profit of 46/63 (68%) is less than three hundred million rupees. This shows that Islamic banks prefer non-PLS financing with firms who are relatively weak in the market. One of the possible reasons is non-willingness by Islamic banks to do PLS financing with weak firms. This reason is supported by one of our meetings with zonal manager of an Islamic Bank in Pakistan. The main points of that meeting are:

- The process of contract finalization is not simple. The Bank considers many factors before taking decisions.

[6] Mean of average profit is Rs. 800 million rupees.

- Such process includes checking previous trends in profits and assets of firm as well as the market share of such firms.
- Some procedures of checking the worth of firms are confidential and are even not disclosed to firms.
- The Bank tries to capture well-reputed firms in the market.

5.3 Regression Estimate

Table 5 shows the outcome of the regression based on the following two regression equations:

$$L_i = \ln\left(\frac{P_i}{1-P_i}\right) = Z_i = = \alpha + \beta_1(\text{Log(AST)} + \beta_2(\text{Log(AP))} + \mu \quad \ldots (2)$$

$$L_i = \ln\left(\frac{P_i}{1-P_i}\right) = Z_i = = \alpha + \beta_1(\text{Log(AST)} + \beta_2\ (\text{Dummy}) + \mu \quad \ldots (3)$$

Table 5. Regression Results

	Model 1	Model 2
	Marginal effects	Marginal effects
log of Assets	-0.0209 (.05096)	.0593 (.0376)
Log of Profits	0.1496*** (.04921)	
Dummy Variable		0.3034*** (.13004)
Pseudo R^2	0.1638	0.1248
AIC	116.203	121.342

AIC and BIC favours first model. *** show significance at 10%.

First, we estimate the regression by including log of profit and log of assets as independent variables. Second, we include dummy variable (which is 1 if Average Profits are greater than the mean value, otherwise 0). In the first model we find that log of average profit is significant which shows that the probability to choose participatory financing with Islamic banks increases if log of average profit increases. If there is one-unit increase in the average profits of firm, then the probability for adopting participatory financing increases by 14%. This result is robust as in the second model the coefficient of dummy variable is also significant. This shows that if a firm surpasses the limit of eight hundred million rupees of average profits, there is 30% more chance of choosing participatory financing.

The regression results do not support the hypotheses of the study. We assumed that strong firms will not do participatory financing with Islamic Banks because it would not wish to share profit with Islamic Banks. But the regression results do not support our conjecture. It appears that strong firms do undertake the contract of participatory financing with Islamic banks. One may ask about the probable reason of this contradictory outcome. The possible reason is that Islamic Banks might have invited strong firms for participatory financing by offering them very attractive ratio in profit. We found some support in favour of this explanation during our telephonic talk with authorities of various firms. Another possible reason could be the diversification of financial contracts with banks. A firm might keep financial relationship with both Islamic and conventional banks. Hence, a firm might enter into financial contracts with both types of banks. With Islamic banks they might be involved in participatory financing, while with conventional banks in interest-based financing.

6. CONCLUSION

Conventional financial system has failed in achieving the objective of circulation of wealth with an economy. The reason is that conventional financial system is based on interest which is the root cause of the failure of circulation of wealth. Islam strictly prohibits interest and encourages the circulation of wealth within an economy. The idea of zakat and different types of charities (like *sadqaat, fitrana on both Eids, ushar etc.*) shows that wealth should flow from rich towards poor people in society. Islamic finance offers participatory mode of finance as an alternative to ensure the circulation of wealth in an economy. This mainly includes Mudharabah and Musharakah.

To achieve the objective of circulation of wealth Islamic banking industry emerged in the world since 1963. However, the objective of circulation of wealth has not been achieved even in Islamic countries. What are the reasons of this failure? Many scholars have provided answers to this question including agency problems and strict competition from conventional banks [Dar and Presely (2000); Febianto and Kasri (2007)]. This work adds to such empirical literature. This paper assumes that the motive of pursuing the objective of profit maximisation is one of the main causes of failure in achieving the objective of circulation of wealth. Consequently, Islamic banks mostly adopt trade based non-risky modes of financing. This situation is against the very purpose for which Islamic scholar were advocating the need of Islamic economics and banking [Moudoodi (2000)].

The hypotheses of the paper are based on the assumption that firms in the market are also maximiser of the profits. Hence, strong firms are less likely to share their profit with Islamic Banks as compared to weak firms, but weak firms have a high risk of loss, which the Islamic Banks avoid by executing PLS contracts with them. The main reason of preferring participatory financing by weak firm with Islamic Banks is that they on average earn low profit hence will have to pay fewer amounts to Islamic Banks. On the other side, if weak firms get loans from conventional bank, they will have to pay fix amount even if it earns low rate of profit.

The present study empirically explores the demand from firms for participatory financing with Islamic Banks. The results reveal that strong firms are involved in participatory financing with Islamic Banks. Likewise, we find a positive and significant relationship between average profits and participatory financing with Islamic Bank. On average the findings provide weak support to the hypotheses of the study as strong firms are doing participatory financing, while we assume that strong firms are less likely to have participatory financing with Islamic banks. However, the hypothesis is partially supported by the high level of (54/63=85%) weak firms doing non-PLS financing with Islamic banks.

The possible reasons for the weak support of the hypothesis relating to strong firms are:

1) The motive of profit maximisation might force Islamic bank to offer high rate of return to strong firms. Such offers benefit Islamic Banks as it solves the issue of agency problem and moral hazard. In addition, such offer provides Islamic Banks an

opportunity to develop a good relationship with such firms, through which Islamic Banks can attract other strong firms from the market. Over time such strong firms become loyal with Islamic Banks and do not switch to other banks for a small incentive.

2) Strong firms have branches all over the country and need regular funding for their functions. A single bank cannot fund them beyond a certain limit, hence in order to diversify they also acquire PLS from Islamic banks. Moreover, they might demand PLS for a sub-project with restricted profits while on average their demand may be for non–PLS finance.

The findings need to be studied with caution. The reason is that data on actual contract between firms and Islamic Banks is taken through telephonic calls. In this regard those firms who avoided sharing information are dropped from the analysis. Not dropping them could make our result biased. Moreover, the information was collected from finance or account section of the firms. While, the appropriate person to reply this question is the owner or the key decision maker of a firm. Likewise, the call receiver may have different projects in mind when replying on phone to our question regarding participatory financing with banks. While, we assume that participatory finance is for all projects of the firms, we suggest future researchers to collect rich data and provide answers of the question this study set out to examine.

REFERENCES

Abdul, M. and A. Sarker (1999) Islamic Banking in Bangladesh: Performance, Problems & Prospects. *International Journal of Islamic Financial Services, 1;* 3. 1-21

Jaffar, M. A. and R. Musa (2014) Determinants of Attitude towards Islamic Financing among Halal-certified Micro and SMEs: A Preliminary Investigation. *Procedia-Social and Behavioral Sciences*, *130*, 135-144.

Camerer, C. (2003) *Behavioral Game Theory: Experiments in Strategic Interaction*. Princeton University Press.

Chapra, M. U. (2008) The Islamic Vision of Development in Light of Maqasid Al Shari'ah, Retrieved in www.muchapra.com, p. 3-4.

Council of Islamic Ideology (1979). Elimination of Riba from the Economy and Islamic Modes of Finance, 2nd Ed, Council of Islamic Ideology, Pakistan

Dar, H. A. and J. R. Presley (2000) Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances. *International Journal of Islamic Financial Services*, *2:2*, 3-18.

El-Gamal, M. A. (2000) *A Basic Guide to Contemporary Islamic Banking and Finance* (Vol. 1). Houston, TX: Rice University.

Gait, A. and A. Worthington (2008) An Empirical Survey of Individual Consumer, Business Firm and Financial Institution Attitudes towards Islamic Methods of Finance. *International Journal of Social Economics*, *35*(11), 783-808.

Hamoud, S. H. A. (1982) Tathwiir al-A'mal al–Mash–rafiyyah Bima Yattafiqu Wasy Syariah al-Islamiah, Amman.

Haque, Z. (1985) *Islam & Feudalism: The Economics of Riba, Interest and Profit*. Vanguard Books, Pakistan.

Haque, Z. and A. A. Kazmi (1993) The Nature and Significance of the Medievel and Modern Interpretations of Riba [with comments]. *The Pakistan Development Review*, 32:4, 933-946.

Hasan, Z. (2002) Mudharabah as a Mode of Financing in Islamic Banking: Theory, Practice, and Problems. *Middle East Business and Economic Review*, 14:2, 41-53.

Febianto, I. and R. Kasri (2007) Why do Islamic Banks Tend to Avoid Profit and Loss Sharing Arrangements Working Paper in Business Management and Finance, No. 200705.

Ismail, D. A. H. (2002) *The Deferred Contracts of Exchange: Al-Quran in Contrast with the Islamic Economists Theory on Banking and Finance*. Institute of Islamic Understanding Malaysia.

Ismail, A. H. (1986) Islamic Banking in Malaysia: Some Issues, Problems and Prospects. *Kuala Lumpur: Bank Islam Malaysia Berhad*.

Ismail, A. G. (2010) *Money, Islamic Banks and the Real Economy*. Cengage Learning Asia Pte. Ltd. Singapore.

Kasri, R. and S. H. Kassim (2009). Empirical Determinants of Saving in the Islamic Banks: Evidence from Indonesia, JKAU: Islamic Econ., Vol. 22 No. 2, 181-201 (2009 A.D./1430 A.H.).

Maudoodi, A (2000) Sood 23rd Reprint (first published in 1968, comprising of the articles written by the author during 1936-1960), Islamic Publications Ltd, Lahore

Maudoodi, A. (2002) Insan Ka Muashi Masla aur Is ka Islami Hal (Economic Problem of Mankind and its Islamic Solution), Islamic Publications Ltd, Lahore.

Asutay, M. (2007) Conceptualization of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of Homo Islamicus by Homoeconomicus. *IIUM Journal of Economics and Management*, 15, 1-17.

Mishkin F. (2004) The Economics of Money, Banking and Financial Markets, 7th ed., Addison Wesley, US.

Mughal, Z. (2017) Convergence between Theory and Practice of Islamic Banking: An Empirical Analysis, Ph.D. Dissertation, School of Economics, Quaid-i-Azam University, Islamabad, Pakistan.

Nienhaus, V. (2011) Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance. *Ethical Perspectives, 18:*4, 591-623.

Erna, R. and S. Ekki (2004) Factors Affecting Mudarba Deposits in Indonesia. Working Paper in Economics and Development Studies. *Padjadjaran University, Indonesia*.

Rafay, A. and R. Sadiq (2015) Problems and Issues in Transformation from Conventional Banking to Islamic Banking: Literature Review for the Need of a Comprehensive Framework for a Smooth Change. *City University Research Journal*, 5 (2), Article 10.

Razi, N. (2014) Socio-Ethical Dimensions of Islamic Economy and Issue of Modern Interest and RIBA: An Analysis in the Light of the Economy of the Muslim World. *Journal of Islamic Banking and Finance*, *2:*2, 27-42.

Rachmawati, E. and Syamsulhakim, E. (2004) Factors Affecting Mudarba Deposits in Indonesia. Working Paper in Economic and

Developing Studies, Department of Economics Padjadjaran (No: 200404).

State Bank of Pakistan (2005) Islamic Banking Bulletins, State Bank of Pakistan.

Siddiqi, M. N. (2004) *Riba, Bank Interest and the Rationale of its Prohibition*. Jeddah: Islamic Research and Training Institute.

Siddique, M. Z (2017) Convergence between Theory and Practice of Islamic Banking: An Empirical Analysis, PhD thesis, School of Economics, Quaid-i-Azam University.

Tahir, S. (2007) Islamic Banking Theory and Practice: A Survey and Bibliography of the 1995-2005 Literature. *Journal of Economic Cooperation among Islamic Countries, 28:*1, 1-72.

Usmani, Mufti Taqi (2009) Interest Free Banking (URDU: Ghair Soodi Bankari), Karachi: Idarah Ma'arafatul Quran.

Warde, I. (2000) *Islamic finance in the Global Economy*. Edinburgh University Press. Edinburgh.