

## Conference Paper

# Profit and Loss Sharing (PLS) and Non-PLS Financing in Malaysia: Which One Should Be the One?

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## Abstract

The motivation in this study lies on the fact that despite the tremendous development of the Islamic finance industry, some scholars argue that the development was driven by the debt-based or non-Profit sharing and losses sharing (PLS) contract instead of the widely proposed Profit sharing and losses sharing (PLS) contracts perceived to be as the ideal mode of financing. The question that arises is why non-PLS based? Why not PLS? Which one should the concepts use in Islamic finance then? Hence, this paper tries to explore the reason behind such development, discuss the future development as well and finally answer the main issue of which one should be the one? Initially the PLS was introduced in Malaysia; however the trend moved to non-PLS as a result of the current situation. The introduction of non-PLS products has been approved by shariah scholars hence making it shariah compliant. Since 'sin' is not an issue anymore, the investors now look for the best instrument that can give them higher return in line with the investment concept of high risk high return. Therefore, both PLS and non-PLS can be used side by side at the present moment.

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Received: 7 February 2020

Accepted: 9 March 2020

Published: 23 March 2020

Publishing services provided by  
Knowledge E

**Keywords:** Profit and loss sharing; Islamic finance concept; Malaysia

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Selection and Peer-review under the responsibility of the ICE-BEES 2019 Conference Committee.

## 1. Introduction

The establishment of an Islamic bank in Malaysia was documented that profit sharing and losses sharing (PLS) should be the main features of an Islamic bank [11]. This is in line with general consensus in other parts of the world advocating PLS as the proposed model reflecting the true spirit of Islam [2, 10]. The PLS differentiates the Islamic financing and its conventional banking counterpart [3, 5]. The “mudharabah” (profit sharing) and “musharakah” (joint venture) were proposed to be employed in the banking business operation as substitute to the interest based banking system, that in line with the shariah requirements as well as to meet the demand of the majority Muslims in the country.

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Notwithstanding the PLS model proposed initially, the bank was set up as a financial intermediary to address the need for the Muslims to save or deposit money similar to the conventional banks in the existed conventional system. [8] highlight a positive effect of the existence of Islamic banking system as it can help to generate positive economic growth as well as increase social welfare by attracting the religious concerned individuals to bank-in their unbanked funds previously held due to religious belief. These shariah concerned individuals is not willing to do banking transactions, unless it operates according to these individual religious belief.

On the broader aspect, the Islamic bank is also expected to operate in the dual financial system within the existed modern conventional system [3]. Malaysia opts for a dual banking system where the Islamic banks will operate alongside the conventional banking system. In a different view, being in the same financial industry with the conventional banks, Islamic banks have to compete with its conventional counterparts. In a nutshell, the establishment of the Islamic bank in Malaysia is merely to complement the existing conventional banking system.

Nevertheless, as time goes by the original plan seems to fade away from the original intentions in line with the world trend, which the debt based financing take charge. In the 70s, the demand for murabahah based financing overshadowed the main concept of profit sharing in Islamic finance. Murabahah or cost-plus financing become the most dominant financing in the Islamic world. It fills the gap of capital protection issues as well as trade based modes not addressed in the early development of Islamic finance [9].

A recent study by World Bank and the Islamic Development Bank in 2017 on Islamic banks transactions indicate that murabahah and deferred sales account for 78.5% and leasing and hire purchase accounts for 10.8% as oppose to the 1.7% and 4.2% for mudharabah and musharakah respectively and Malaysia is not spared as well. In terms of concept, in 2016 alone, the PLS concepts accounts for minimal 9% out of the total financing disbursed (asset side of the balance sheet) in Malaysia.

Notwithstanding the above excellent development, the composition of the concepts employed in the financing side of the Islamic banks is quite obvious where majority of the assets are derived from the debt-based and leased-based financing (known as non-PLS). This is far beyond the original intention of Islamic banks establishments. Figure 1 depicts the composition of Islamic banks financing in Malaysia by concepts where only RM9.3 billion and approximately RM1 billion worth of musyarakah and mudharabah financing respectively in 2016 alone as compared to the overall total of RM436 billion worth of Islamic financing.

End of period	Bai Bithaman Ajil	Ijarah Ijarah	Ijarah Thumma		Musharakah	Mudharabah	Istisna'	Others	Total Financing
			Al-Bai	Murabahah					
2012	74,200.40	4,922.50	54,103.9	0	11,940.10	142.2	1,584.60	46,025.90	232,918.90
%	31.9	2.1	23.2	17.2	5.1	0.1	0.7	19.8	100
2013	83,141.30	6,652.80	62,489.8	0	16,374.60	146	1,476.50	53,898.00	281,429.10
2014	79,784.80	8,125.40	69,236.3	0	22,733.60	77.3	1,766.90	68,696.70	335,385.10
2015	75,661.20	9,692.30	71,771.0	0	28,749.60	77.8	2,238.20	82,062.80	393,956.90
2016	69,321.40	9,845.60	70,054.0	0	40,423.60	71.4	2,060.90	82,563.00	436,708.40
%	15.9	2.3	16	37.2	9.3	0	0.5	18.9	100

Figure 1: Islamic Banking Financing by Concept (BNM Monthly Highlights and Statistics December 2017).

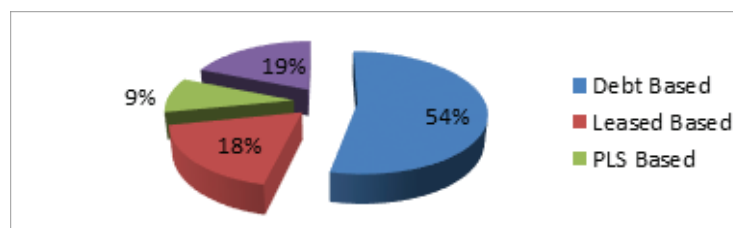


Figure 2: Islamic banking business by Concept, 2016.

Despite the tremendous development of the Islamic finance industry, some scholars argue that the development was driven by the debt-based or non-PLS contract instead of the widely proposed PLS contracts perceived to be as the ideal mode of financing. The question that arise is why debt-debt or non-PLS based? Why not PLS? Which one should the concepts use in Islamic finance then: Is it PLS or debt-based or non-PLS? Hence, this paper tries to explore the reason behind such development, discuss the future development as well and finally answer the main issue of which one should be the one?

## 2. Literature Review

In Islam, the Muslim must follow what god have permit and let go of the one which is forbidden. Riba for instance is forbidden in Islam as it is a form of oppression to the weak, normally the poor. Riba is usury or excessive interest charged to a loan, and some people view it as predetermined rate of return. Apart from riba, Gharar or uncertainty is also not permitted as it leads to again the oppression of the weak and lead to a zero-sum game which most likely benefited one party at the expense of other party. Muslims are also not allowed to undertake non-halal activities such as gambling, alcohol, pork sell and consumption, prostitution, tobacco and so on. As Islam is a way of life, these muamalat and the religion is very much connected and not separated.

## 2.1. Profit and Loss Sharing (PLS)

Profit and Loss sharing concepts was the initial concept underpinning Islamic banking and finance. In the earlier era, scholars formed the PLS paradigm in addition to the adoption of shariah legislations, abolishment of non-interest based transactions and promoting social justice and fairness (Chapra, 1979). The lender in this type of loan is not exposed to business risk but yet received a fixed income. Hence, a 'profit and loss' concept is emphasized. As human, we have no control over the final outcome of the business and therefore both the borrowers, lenders or investors must each bear the risk.

The PLS refers to the so called participatory transactions in the financial world mostly through the concept of mudharabah (profit sharing) and musharakah (joint venture). The risk sharing is believed to contribute to sustainable developments by funding the untapped opportunities in the emerging and developing countries. Apart from the abolishment of riba, PLS makes Islamic finance unique since it differentiates the Islamic and conventional banking.

Mudharabah is a profit sharing concept where two parties, (1) the capital provider/ financier known as Rab-UI-Mal provides 100% capital while the other party is (2) the entrepreneur known as the Mudarib, runs the business. Both parties are bound by a partnership contractual relationship, however the Rab-UI-Mal acting as a sleeping partner. In this arrangement, the financier cannot interfere in the running of the business by the entrepreneur. In the event of loss, the financier is to bear all the losses, while profit if any shall be shared between the two party in a predetermined agreed ratio. The Islamic banks thus far have treated mudharabah as equivalent to equity financing.

Musharakah on the other hand is a joint venture contract where the bank and the customer jointly contribute capital and manage businesses or projects. Any profit or loss will be shared together based on a predetermined ratio decided earlier prior the commencement of the projects. Scholars such as Chapra (2007), [9] and [10] are of the opinion that Musharakah financing is the true spirit of financing in Islam as it promotes justice which is the primary vision of Islam. This is because Musharakah financing apply risk-sharing principle so that the business risks are not shifted solely to the entrepreneur. Moreover, there is an equitable distribution of financing since it is not restricted to those who have collateral and strong financial back up to pay the predetermined profit payment.

## 2.2. Non-PLS

Apart from the PLS concept, the non-PLS concept is also allowed in Islam. This includes the debt-based contract such as murabahah, Bai Bithaman Ajil and leased based such as Ijarah were introduced in the market.

Murabahah is a cost plus or mark-up concept. Normally the bank will buy specified assets and later to be sold to the customer at a cost plus profit where both the cost and profit is disclosed to the customer. An example is in the working capital financing or trade financing. This financing conquered majority of the current Islamic bank financing assets. The concept of Al Bai Bithaman Ajil is a deferred payment sale where the bank buys an asset and later resold to the customer at a profit. The customer will pay the balance due via instalment payment. In this arrangement, the bank is not required to disclose the selling price to the customer. It is also known as Bai Muajjal. This type of financing is suitable for long term financing with huge amount involved for instance house or landed property financing.

Ijarah is a leasing agreement between the bank and the customer. The bank will buy a specified asset identified by the customer and later lease it to the customer for a rental fee. The customer will benefit from the usufruct of the assets and bank gain in the rent. One thing which is obvious is that the asset ownership belongs to the bank and not the customer and therefore the bank takes the risk. An example on application of this concept is vehicle or heavy machinery financing.

Bai Salam is structured based on a forward based contract. In this method, an entrepreneur can sell the specified assets today at a specific price with payment received upfront while the delivery of the goods take place in the future when the assets is available. While Istisna is a contract based on commissioned or contract manufacturing whereby a party promise to produce specific goods at a price determined today and again delivery will take place in the future. It can be used in the financing of infrastructure projects construction and manufactured projects.

In this paper, due to time limitation we do not discuss the advantage, disadvantages, failures or success of both PLS or debt-based financing. The aim is to look at the factors for the changes in the trend from the PLS, considered as the ideal form of financing at the inception, to the non-PLS instruments, and look at the way forward.

### 3. Current Scenario: Why Debt-Based Financing/Non-PLIs? Why Not PLIs?

This section discuss on the reason why the debt based financing or the non-PLS is popular as compared to PLS concepts.

#### 3.1. Banks' Perspective: The Business Decision

While the bank's customer may have different reason for engaging with the Islamic bank, for instance religious and ethical reasons, the Bank's management may have a slightly different reasons which suits its business entity [1, 3]. Figure 1 substantiates the bankers' preference on non-PLS financing over PLS financing. Since bank incorporate a banking business model with profitability as the main KPI, banks have no other choice but to find ways to register decent profit to ensure its future survival. The competition between them makes the Islamic bankers had to explore more innovative ways of doing banking business.

The emergence of debt-based and leased-based financing, particularly on product engineering and product innovation, arise from the difficulties in implementing the concept of musharakah and mudharabah financing. The management of Islamic banks had taken the initiative to promote debt based financing as a model which is easy to implement, as it resembles the conventional banks products coupled with low risk, as compared to the PLS model. Majority of the bankers are less interested on risky assets, and this is also true for some of the banks customers. Besides the business decision, debt based financing justify the Islamic tenets of shariah compliance activity.

Khan and Ahmad (2001) compares various model of financing such as mudharabah, musharakah, salam, ijarah, istisna' and diminishing murabahah and finally concluded that debt-based murabahah concept is the least riskiest in terms of credit risk and comes second least risky in operational and liquidity risk. This fits the intermediary role of the Islamic banks structure which prefers to avoid risk since their role itself is an intermediary that received deposits and gives out credit to their customers. In such structure, shifting the risk or taking the risk at its lowest level will be deemed as the best option.

[7] also highlight that the biggest problem to bankers is agency problems concerning information symmetry and moral hazards. Information asymmetry resulted in adverse selection where loans or financing are granted to a client with poor credit standing and moral hazard is where loans or financing are used in appropriate way. Entrepreneurs

in the PLS structure may hold or hide important information about the company's information for their self-interest and hence expose the bank into high risk. Again, these lead to a higher risk in implementing banking business. To mitigate these risks, the bank opts for the debt based contract.

The PLS contracts is based on trust on the parties involved. However, the sad story is the trusts are sometimes taken lightly by the parties involved. The bankers have to take steps to reduce the risk by way of thorough monitoring procedure or face losing the money financed or invested in a particular exercise or projects. Heavy monitoring incurs additional cost to the banks coupled with the risk of losing due to non-expertise in the business dealing or project undertaken.

### **3.2. Customer's Perspective: The changing appetite of shariah compliant concerned investors**

Interestingly, in a study on the capital market scenario, [4] postulated that the Islamic debts instrument such as Islamic bonds and Islamic equities has been allowed to jointly crowd out the original Islamic risk and return (musharakah) instruments. The musharakah concepts, considered as the main and original concept at the inception of Islamic finance, was forgotten simply because the shariah standard has given legitimacy to other financial structures as a results of product innovation in Islamic finance industry. They argued that once the investors' intrinsic need for shariah compliance is fulfilled, the instruments risk-return features become more important in deciding between debt-based or equity-based instruments. As such, many opt to invest in the non- PLS instruments and making the musharakah failed to emerge as the preferred instruments.

The same scenario happens in the banking industry where the emergence of non-PLS instruments such that debt-based instruments, has taken over the popularity of PLS instruments. One thing that PLS and non-PLS has in common is both are Shariah compliant. [1] is of the opinion that in practice, bank is not labelled less Islamic for having less PLS financing. The public too perceived the same as long as the products are legally shariah compliant, the issue of the preference on PLS over non-PLS does not exist, but rather the choice is which concepts resulted in higher return with the lowest or acceptable risk. Hence, profitability or return is the bottom line as these customers are savers and investors who put return as the main objective, of course after satisfying the shariah requirements. Given that the non-PLS instruments are shariah compliant, their concern now turns to the best returns offered by the respective instruments.

### 3.3. The On-going Dilemma

PLS makes the Islamic banking unique and different from the conventional banking [5]. However, PLS in theory and practice seems did not jive. The strategy to opt for debt base financing is merely a business decision with the intention to uphold the Islamic bank to be seen as competitive as its other counterparts in the financial system. However, the real intention of Islamic finance is compromised unintentionally. The values of having a shariah compliance banking activity is preserved however unintentionally again, most of the products mimic the conventional loans packaged as shariah compliant loans.

[5] studied the Islamic banks in Malaysia and found evidence to state that in practice the Islamic bank is no different from the conventional one. At one end, the asset side is dominated by the non-PLS modes of financing. Although shariah permissible, the products are similar to the conventional products. At the other end, the deposit rates for instance are tied to the conventional rates. The Engel- Granger methods used in their study suggest that the Islamic rates changed by the movement of the conventional rates and not the other way around. They also posit that the success of the Islamic banking then was not because of the PLS system but owing to the worldwide Islamic resurgence since the late 1960 that spurred demand including in Malaysia.

In the initial phase, shariah scholars have diverse opinions. It was well understood that change to non-riba banking system will takes time. People are so comfortable with the conventional system and to switch to an Islamic system will be definitely a painful experience, but not to the obedient Islamic follower. [10] for instance is of the opinion that murabahah transaction should be done with careful monitoring. It should not be done in the first place however for maslahah issues especially applicable at the time when other financing is not practical or available. Effort has to be done to eliminate the use of this types of financing for the PLS concepts preferably. Other scholars including Pakistan's Council of Islamic Ideology states that although the debt-based financing is permissible, it should be restricted or avoided to prevent from the idea of back door riba [5].

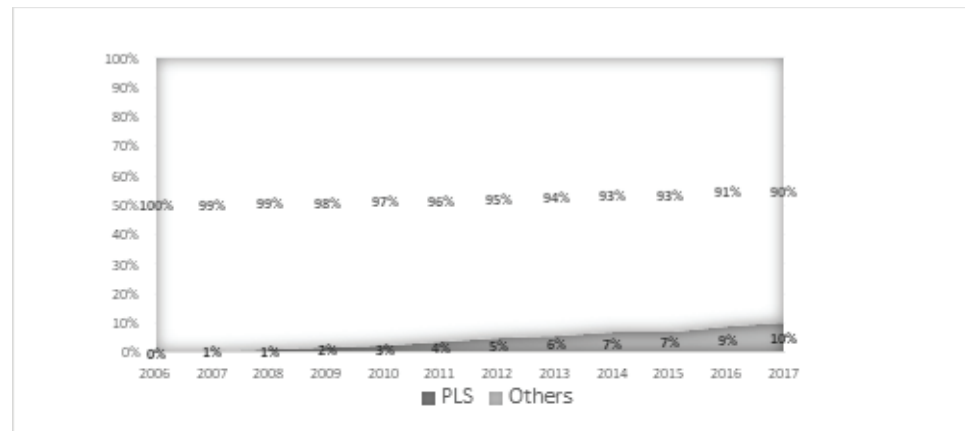
## 4. Where Are We Heading?

### 4.1. The Changing Trend

Recent figures show an encouraging potential towards PLS concepts. As evidenced by the BNM figures, debt-based financing continues to dominate the Islamic financing



products. Notwithstanding the above, it should not be neglected that the growing numbers in the PLS participation, although at a slow pace seems to imply that the demand is there.



**Figure 3:** Islamic Banking System by Concept (BNM Monthly Highlights and Statistics December 2017).

Interestingly, notwithstanding the low rate of PLS as oppose to the rest of the financing in investment method, the rate of PLS share is increasing marginally, signalling the interest for PLS method. Within the last ten years, it grew from less than 1% in 2006 to 10% in 2017. Hence, the next question is can the rate increase further? For the majority Malaysian muslims, god willing, sure hope for the best. As per the initial years of the Islam banking operations, the support from the religious Muslims who dream of having non-interest transaction created demand for better shariah compliant products. Having the knowledge that the present Islamic banking system is not perfect and in need of further improvement, PLS which is deemed to be better should create huge demand.

## 4.2. Regulatory Support

Apart from the above, Bank Negara Malaysia being the regulator for the financial industry has shown some signs to further improve the Islamic financial system. BNM has introduced the Policy Documents to standardize the operational parts where it outlined how IFIs in the country should carry the Islamic banking business to ensure compliance of the shariah requirements.

1. In 2012, the Profit Equalization Reserve (PER) was withdrawn as this encourage income smoothing to shield depositors from losses. With this move, Islamic banks have the choice whether to continue imposing PER or not.
2. The latest move to introduce the Investment account is a strong and convincing move towards the PLS system. PLS based investment accounts have now its own

category separated and distinguished from the normal savings account. Under the IFSA 2013, one of the concerns is to distinguish Islamic Deposits and Islamic Investment Account. The investment account is a non-guaranteed investment and not covered under the Perbadanan Insuran Deposits Malaysia (PIDM). The account is structured with various risks and return profile associated with the assets involved.

3. The investment account platform (IAP) was also introduced where this platform helps to gather the financiers and businesses to meet for the purpose of raising funds for businesses using the investment concept of mudharabah and musharakah.

### 4.3. Main Financier to SMEs

[6] highlighted the growing interest in the PLS concept, be it in neither the academic world nor the banking industry. Experimental evaluation has shown the promising contribution of the PLS in the microfinance in both Islamic and non-Muslims countries. Recent study shows that significant portion of the SMEs financing in Turkey is supported by the Islamic banks. This shows strong interest in PLS concepts by the SMEs. PLS is argued to support the SME through direct labor participations and its involvement in the real sector which in return has direct impact to the economy and the social aspects.

A study by Nur Hasnida Abd Rahman (2017) demonstrates SMEs' agreement on the bank's participation in their business operations, thus indicating the potential of using Musharakah concept as a viable financing for Malaysian SMEs. In addition, the National 2015 budget had announced the introduction of shariah compliant investment platform namely the Investment Account Platform (IAP) developed by a consortium of Islamic banks bringing internet based multi banks fintech revolution in the industry by gathering investors and the SMEs particularly and businesses to raise funds and invest in a single platform. Investors can now choose preferable investment with preferable risk and return [3]. The move has brought different roles of the Islamic banks by acting as the intermediary which channelling funds of investors and fund seekers with viable ventures. This is an excellent move to encourage musharakah and mudharabah financing concepts in the Islamic bank.

## 5. Conclusion

In the first place, the tremendous development of Islamic finance is awesome. Initially the PLS was introduced; however the trend moved to non-PLS as a result of the current situation, particularly the limitation of the mudharabah and musharakah concepts. Since the industry is supply driven controlled and dictates by the bankers, the Islamic banks having a business models must find ways to maximize its bottom line and reduces risks or they will be out of business due to business competition including from the conventional financial institutions. Debt-based at the present moment provides the best solutions for the business people.

One thing for sure, the introduction of non-PLS products has been approved by shariah scholars hence making it shariah compliant. Hence, to the shariah concerned investors, their religious part of dealing with so called halal and shariah compliant instruments has been compliant with. Since 'sin' is not an issue anymore, the investors now look for the best instrument that can give them higher return in line with the investment concept of high risk high return concept. Therefore, both PLS and non-PLS can be used side by side at the present moment.

Notwithstanding the above, if the problems arises from the mudharabah and musharakah can be overcome, investors should find ways and put effort to go back to the initial concept during the introduction of the Islamic finance i.e. the PLS. They only reason why non-PLS was introduced was because if the said problems. Islamic scholars have also suggested that the debt-based contract is permissible but with careful monitoring. It shouldn't be done in the first place however for maslahah issues especially applicable at the time when other financing is not practical or available.

The present moment requires the usage of the debt-based and leased-based concepts. Things may change if the situation has changed. Only time will tell. In the future, the PLS will continue to be the theme in Islamic banking. However, the non-PLS will be there until such point that the PLS is acceptable and debt-based is no longer relevant, business wise and religion wise.

Islamic banking in Malaysia is still a nascent industry and has many more years of nurture before it can become matured and competent as the long established conventional bank. History shows that the evolution of Islamic banking moves in stages. For Malaysia, the country has successfully implemented the Islamic banking system, meeting its target to complete the 30 years of Islamic banking ambition. The roots of the system have been well planted and it is about time that the system starts to bear

flowers and fruit towards the end of this journey. It will never end, and therefore the country must keep up the pace.

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