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Author(s): Nagaoka, Shinsuke

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Reconsidering Mudaraba Contracts in Islamic Finance: What is the Economic Wisdom (Hikma) of Partnership-based Instruments?*

NAGAOKA Shinsuke**

1. Introduction

In Islamic economics and finance, a wide range of consensus has been reached on the fact that of all the financial instruments, partnership-based instruments are the most preferable. This consensus is unanimously supported in terms of the juridical aspect, and also supported by a certain economic aspect relating to the economic doctrine of Islam. With respect to the economic aspect, the use of partnership-based instruments is justified by the fact that when using these instruments, the manner in which profit and loss is distributed is such that any risk involved in partnership-based instruments is properly shared by both parties. This spirit of sharing (risk-sharing) is highly consistent with one of the fundamental notions of Islamic teachings.

However, when the negative effects of securitization, which appear to be one of the risk-sharing instruments, as represented by the subprime mortgage crisis in recent years, are considered, characterizing partnership-based instruments as risk-sharing ones is not necessarily sufficient to describe the substantial economic implications of these instruments. Therefore, this presentation aims to reconsider such an economic implication of partnership-based instruments by thinking back to partnership contracts in premodern times and then reformulating their economic wisdom (hikma), which will become a milestone for the future vision of Islamic financial practice.

2. Partnership-based Instruments in Islamic Economics

As mentioned in the previous section briefly, since the revival of arguments and academic studies on the Islamic economic system in the mid-twentieth century (these studies are generally called “Islamic economics”), there appears to have been a consensus with regard to the arguments concerning which financial instruments should be adopted in the reconstructed Islamic economic system. Most Islamic economists encouraged the use of partnership-based financial instruments like mudaraba and musharaka contracts.

* An earlier version of this paper was presented under the title of “Economic Wisdom (Hikma) of Partnership Contracts in Islamic Economics: Reconsidering the Risk-Sharing Schema” at International Workshop in Islamic Economics, Banking and Finance (7-8 July, 2008 at School of Government and International Affairs, Durham University, UK).

** Ph. D. Student, Graduate School of Asian and African Area Studies, Kyoto University, JAPAN; Research Fellow of the Japan Society for the Promotion of Science (JSPS)
The Mudaraba contract is a form of a business contract in which one party offers capital and another party undertakes some business with this capital; the former is termed *rabb al-mal* and the latter *mudarib*. The profit is distributed between both parties in a ratio agreed beforehand while the entire loss is born by *rabb al-mal* unless *mudarib* has a defect (see Fig. 1).

**Fig. 1: Principle of Mudaraba**

The Musharaka contract is a form of a business partnership in which multiple parties invest. In Islamic finance, *sharika al-inan* is used as a variation of *musharaka*. The profit is distributed between both parties in a ratio agreed beforehand according to Hanafi school and Hanbali school of Islamic law, meanwhile shared in depending on the amount of investment according to Maliki school and Shafii school. On the loss being born depending on the amount of investment, there is the consent of each school. A right to participate in managing their business partnership is given investors, but this right is entrusted to each investor (see Fig. 2).

**Fig. 2: Principle of Musharaka**

One of the early Islamic economists, Anwar Iqbal Qureshi, had already mentioned
partnership-based banking systems in his book published in the 1940s:

Islam prohibits interest but allows profits and partnership. If the banks, instead of allowing loans to the industry, become its partners, share the loss and profit with it, there is no objection against such banks in the Islamic system [Qureshi 1945: 158–159].

Around the same time, Mahmud Ahmad also stated his preference for partnership-based systems:

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: 170].

According to an earlier overview by Muhammad Nejatullah Siddiqi [Siddiqi 1981], this consensus with regard to the most preferable financial instruments had been widely shared both by experts in Islamic jurisprudence and scholars specializing in economics until the end of the 1960s. For example, Muhammad Baqir al-Sadr formulated the partnership-based banking system as a preferable Islamic economic system [al-Sadr 1977 (1969)]. Moreover, Muhammad Uzair presented the core mechanism of the partnership-based banking system from the viewpoint of economics [Uzair 1955], and Siddiqi himself promoted such a system in his book and evolved it suitable for the modern banking system under the name of “two-tier mudaraba” [Siddiqi 1983 (1969)] (see Fig. 3).

![Diagram of Two-tier mudaraba](image)

Fig. 3: “Two-tier mudaraba” suitable for the Modern Banking System

3. Partnership-based Instruments in Islamic Finance

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1 There “shirakat” indicates the principle of musharaka contracts.
The rise of the practice of Islamic finance in the 1970s proved that partnership-based instruments are not necessarily suitable for most aspects of the practice of Islamic finance (particularly its asset aspect). This implies that the majority of Islamic banks in both the Middle East and Malaysia did not actually adopt partnership-based instruments as core financial products but showed a widespread preference for *murabaha* contracts, which are not partnership-based\(^2\).

However, it appears that not only most Islamic economists but also many practitioners who engage in non-partnership-based financial operations on a daily basis firmly regard partnership-based instruments as the ideal financial instruments for the Islamic economic system. For example, Saeed al-Ghamdi at Al-Rajhi Bank in Saudi Arabia argues that although the present emphasis on the non-partnership-based financial system is acceptable, this system should be phased out once Islamic finance evolves into a much bigger and more developed system\(^3\). This appears to imply that non-partnership-based instruments should be replaced by better instruments, that is, partnership-based instruments. In fact, according to author’s hearing investigations of several Islamic banks in the Gulf countries, many practitioners emphasize the change in their practice from involving the use of non-partnership-based instruments to involving the use of partnership-based instruments. Ibrahim Warde reports that as a result of the criticism of non-partnership-based instruments, many Islamic banks started phasing out the elements of such instruments, particularly *murabaha* contracts, which had been subject to criticism [Warde 2000: 134].

Thus, partnership-based instruments have maintained their position as the first best solution for the Islamic economic system throughout the history of both Islamic economics and Islamic financial practice.

### 4. Economic Wisdom of Partnership Contracts in Existing Literatures

Why do partnership-based instruments appear so preferable? Off course, this can be explained from the juridical aspect relating to the textual authenticity of partnership-based instruments. This paper mainly focuses on the economic advantage of partnership-based instruments in light of their conformity with the ideals of Islamic teachings. As it has already been mentioned above, partnership-based instruments adopt a profit-sharing and a substantial loss-sharing procedure in distributing any resulting profit [Siddiqi 1985]. Here again, any resulting profit from *mudarabah* contracts is distributed

\(^2\) Such a preference for non-partnership instruments can be observed almost throughout the period beginning from the 1980s until now. Some examples of actual figures are shown: Table 1, 2 and 3.

\(^3\) Al-Ghamdi’s argument is quoted from [Sum 1995: 95].
between both parties on the basis of a previously agreed upon ratio, while the entire loss is borne by the *rabb al-mal* (capital provider). In the same manner, any profit from *musharakah* contracts is distributed between both parties on the basis of a previously agreed upon ratio or shared depending on the amount invested, while loss is borne on the basis of the amount invested.

The essential point of profit-loss-sharing is to “share” any result by all relevant parties. In terms of economics, any risk involved in partnership-based instruments is shared by all relevant parties, which implies that all the relevant parties are allowed to access any resulting profit in return for bearing a reasonable risk of loss. As many Islamic economist and practitioner working at *Sharia* division of Islamic banks emphasize, this manner of “risk-sharing” is said to be highly consistent with one of the fundamental notions of Islamic teachings [Bendjilali 1996: 44; Kahf and T. Khan 1992: 22]. Therefore, “risk-sharing” has been considered as the economic wisdom of partnership contracts in existing literatures.

5. Some Criticisms of Partnership Contracts

Despite the fact that partnership-based instruments are widely accepted as the first best solution and are also widely considered to conform to Islamic teachings, these instruments have been criticized from various viewpoints including both theoretical and practical aspects. Previously, criticisms of partnership-based instruments mainly attract lots of attention from the viewpoint of practical interests; however, the author believes that several criticisms outlined below contain some clues for the reconsideration of the economic wisdom of partnership contracts. Therefore, the following three criticisms are picked up according to the argument described later.

1) Marxist criticisms: The first criticism concerning the use of partnership-based instruments was stated in Marxist economics. Zuaul Haque highlights a problem in the light of the exploitative relationship between rabb al-mal and mudarib by analogizing the relationship to that between capitalists and laborers or between developed and developing countries [Haque 1985: 215-222]. In his argument, the exploitative nature of rabb al-mal is emphasized in that rabb al-mal unfairly derives excessive profits from partnership-based instruments. He concludes that such a dyadic relationship resulting from the use of partnership-based instruments leads to macroeconomic inconsistence as typified by the imbalance between developed and developing countries.

However, his argument has several flaws. First, with respect to the exploitative nature of rabb al-mal, Haque’s critique does not necessarily hold true because as per a general rule
of partnership-based instruments, the profit sharing rate is not always determined such that it is to *rabb al-mal*'s advantage over that of *mudarib*, but, on the contrary, is negotiable between both parties. Second, there is a huge gap in Haque’s logic regarding macroeconomic effects of the dyadic relationship.

Nevertheless, it seems worthwhile to reexamine both points raised by Haque. With respect to the first point, which has been mentioned solely for the purpose of highlighting the issue of the argument in this paper, the argument pertaining to the exploitative nature of *rabb al-mal* will be reexamined with regard to “the fundamental Marxian theorem (FMT)” formulized by two Japanese mathematical Marxist economists, Okishio Nobuo and Morishima Michio [Okishio 1963; Morishima 1973]. They revealed the exploitative nature of the ordinary economic exchange of commodities premised by Neo-classical economics. With respect to the second point, although the macroeconomic effects of partnership-based instruments have never been logically examined, it is extremely important to examine such effects when we regard Islamic financial practice as a part of the comprehensive Islamic economics system. Therefore, we should address this aspect to ascertain whether the macroeconomic effects of partnership-based instruments are positive as most Islamic economists would like to believe, or negative, as pointed out by Ziaul Haque.

2) Incentive Problem: The second criticism is related to the microeconomic structure of partnership-based instruments. As indicated by many studies, from the viewpoint of microeconomics, the use of partnership-based instruments in Islamic finance get involved in the incentive problem, which implies that the use of partnership-based instruments cannot result in the most efficient solution owing to the asymmetry of information between *rabb al-mal* and *mudarib*. Generally, asymmetric information leads to “adverse selection” in the period before a contract is entered into, and “moral hazards” in the period after a contract is entered into. It is rightly said that the unpopularity of partnership-based instruments in the practice of Islamic finance is due to the theoretical implication that the gap of the asymmetric information between the parties involved in the use of partnership-based instruments is relatively larger than that in the case of the gap between the parties involved in the use of non-partnership-based instruments. Further, the cost for reducing such asymmetry (for example, the monitoring cost) is higher [S. R. Khan 1987: 151]. Thus, *rabb al-mal* needs to bear the additional cost of monitoring *mudarib*’s behavior and induces him to manage his capital efficiently.

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4 The FMT showed a correspondence between the existence of exploitation and the existence of positive profit derived from equation of marginal productivity of labor and capital, which is generally formula of microeconomics.
Although many studies provide theoretical implications to overcome this incentive problem both in modern and Islamic economics\(^5\), their framework is based on the analysis of the dyadic relationship between *rabb al-mal* and *mudarib*. However, it appears to be more important to consider the types of partnership, which means the number of *rabb al-mal* and *mudarib* because the impact of asymmetric information would be dependent on such types of partnership. This implies that the impact of asymmetric information in the case of a hundred *rabb al-mals* and one *mudarib* would be different from that in the case of one *rabb al-mal* and one *mudarib*. Therefore, the incentive problem inherent in partnership-based instruments used in Islamic finance should be reexamined from this viewpoint.

3) *Sharia Arbitrage*: Almost all instruments used in Islamic finance are reconstructed and recompiled as financial products from commercial contracts that were used in the premodern Islamic world or were accepted by the premodern Islamic jurisprudence. Owing to the rapid growth and diversification of Islamic financial practice, new financial instruments (e.g., *bay al-dayn*, *bay al-ina*, *sukuk*, *tawarruq*, Islamic derivatives, etc.) were requested, innovated, and welcomed in the financial practitioner’s field. In response to such continual innovation of Islamic financial instruments, some scholars criticized the manner in which innovation was taking place. They pointed out that such contemporary innovations only adopted the premodern heritage in terms of a commercial contractual “form” and condemned the fact that these innovations did not succeed in capturing “substance” (economic wisdom, *hikma*) of the premodern contracts. Mahmoud El-Gamal terms such innovation as “*Sharia Arbitrage*” [El-Gamal 2006].

El-Gamal defines “*Sharia Arbitrage*” as “forbidding some transaction, and then permitting it in slightly modified form, with unaltered substance” [El-Gamal 2006: 148-149], and explains more concretely in his other article: “the practical solution—which I call “*Sharia Arbitrage*” —is to use legal devices to restructure interest-bearing debt, collecting interest in the form of rent or price mark-up. Designing such instruments and their certification as "interest free" constitutes the bulk of Islamic finance”\(^6\).

El-Gamal, in his book, selects several financial instruments and criticizes them from the viewpoint of “*Sharia Arbitrage*” and then provides several proposals for a desirable system in Islamic finance. Such proposals are based on his original analysis—conducted using the framework of modern economics—on the substantial economic meaning of

\(^5\) First work theoretically mentioning to the incentive problem in Islamic economics would be [W. M. Khan 1985].

economic doctrines in Islam (e.g., prohibition of *riba* and *gharar*), which provide the basic guidelines for the premodern contracts. With respect to partnership-based instruments, he also mentions partnership-based instruments and criticizes, for example, the existing partnership-based deposit accounts in Islamic banks by using the two-tier *mudaraba* and then proposes a new corporate structure of Islamic financial institutions based on mutual banking [El-Gamal 2006: 155-157, 166].

Considering his argument on partnership-based instruments, however, it appears that he does not sufficiently develop his idea in accordance with the result of his analysis on the substantial meaning of economic doctrines. Therefore, his proposal for partnership-based instruments in present financial practice is considered to be lacking in a sufficient explanation. Therefore, the substantial meaning of partnership contracts should be examined in greater detail by thinking back to the economic wisdom (*hikma*) of partnership contracts in premodern times.

6. Two-Edged Blade of Risk-Sharing Instruments in Conventional Finance

Characterizing partnership-based instruments as risk-sharing ones economically reflects the ideals of Islamic teachings to some tune. However, when the negative risk-sharing instruments used in conventional finance is considered (especially in case of the negative effects of securitization, which appears to be one of the risk-sharing instruments, as represented by the subprime mortgage crisis in recent years), such a characterization of partnership-based instruments are not necessarily sufficient to describe the economic wisdom of partnership contracts because if such a characterization were correct, the same characterization which is risk-sharing would be shared by both notorious subprime mortgage in conventional finance and prestigious partnership-based instruments in Islamic finance! Therefore, the author believes that the economic wisdom of partnership contracts should be reconsidered by taking some criticisms mentioned above into account in order to distinguish partnership-based investments in Islamic finance from securitized instruments in conventional finance.

Prior to this reconsideration, this paper will briefly review the advantages of risk-sharing instruments in conventional finance, and then state the negative aspects of risk-sharing instruments, which is revealed in the subprime mortgages crisis.

Owing to the rise of joint-stock companies or the introduction of several securitized instruments, the common purpose of introducing these instruments is to provide adequate liquidity to those who engage in business. These instruments enable these individuals to access a significant amount of funds by mitigating risk, which is shared by the investors
in the form of shares or securities. On the other hand, these instruments also enable individual investors to join in business with small amount of capital. It is appropriately said that such instruments, particularly the structure of joint stock companies, pushed the early transition to a capitalist economy in the Western countries in the eighteenth and nineteenth centuries.

However, the subprime mortgages crisis in recent years revealed that the use of risk-sharing instruments may result in the risks (arising from using these instruments) being scattered across various sectors. Further, once the negative impacts occur not only in the relevant business but also somewhere in the chain of risk-sharing, their influence, particularly at the macroeconomic level, easily spreads to all the sectors involved in similar situations. Such a negative effect of risk-sharing is not only often the case with the subprime mortgage crisis but is also the case with several events caused by risk-sharing instruments (e.g. international turmoil by the turndown of the stock price). As Otaki Masayuki clearly points out [Otaki 2008: 109], securitized instruments, which are based on the transfer of risk from banks to the investors or citizens, have the potential to cause more harmful effects because such transfer from those who have enough knowledge for managing risk to those who do not may increase the extent of asymmetric information, which, in turn, results in risk-scattering. Thus, risk-sharing instruments have both positive effects (risk-sharing) and negative ones (risk-scattering) like a two-edged blade.

7. Reconsidering the Economic Wisdom of Partnership Contracts

What can we learn from the consequences of risk-sharing instruments in conventional finance as in the subprime mortgage crisis? The abovementioned analysis on risk-sharing instruments clarifies that characterizing partnership-based instruments as risk-sharing ones is not sufficient to distinguish the partnership-based instruments from conventional risk-sharing instruments. In particular, this is true of the contemporary innovations in Islamic finance that partnership-based instruments like sukuk al-mudaraba and sukuk al-musharaka are similar to conventional risk-sharing instruments. Such a statement reveals that it is difficult to counter the above criticisms because characterizing partnership-based instruments as risk-sharing ones with including the risk-scattering aspect, at the same time, does not necessarily endorse macroeconomic positive effects, and in today’s world where financial liquidities are provided by more segmentalized shares or securities, the possibility of an increase in asymmetric information has become more crucial. Therefore, if promoters keep considering partnership-based instruments as most preferable, they should discover their renewed or additional economic wisdom.
Alternatively, if partnership-based instruments are truly most preferable, there should be other substantial economic wisdom. This paper supports the latter stance, inquires about further implications by thinking back to the partnership contracts in premodern times, and clarifies the substantial wisdom of partnership contracts, which is helpful in improving partnership-based instruments in present Islamic financial practice. Note that the following examination does not necessarily intend to deny the existing characterization of partnership-based instruments. Rather, it intends to reformulate it from the macroeconomic aspect.

Many studies point out several differences between the original partnership contracts in premodern times and those reconstructed in Islamic finance today as partnership-based instruments. Numerous *fatawa* (legal opinions) issued by Islamic financial institutions for the purpose of the reconstruction of original partnership-based instruments into those that are suitable for modern financial practice also show that there are many differences between them. Among these differences, an issue relating to my argument that merits particular attention concerns the concept of corporate entity in partnership contracts. As Udovitch points out, in the classical Islamic jurisprudence, the concept of corporate entity in partnership-based instruments was not sufficiently developed without one exception, resulting in corporate structures not becoming prevalent in many fields of economic activities in the premodern Islamic world [Udovitch 1970: 98-99]. The historical facts that subsequent generations succeeding to their family business in the premodern Islamic world was a rare occurrence has supported the underdevelopment of the concept of corporate entity in the classical Islamic jurisprudence [Kato 2002].

Although the argument on the existence of the concept of corporate entity in classical Islamic jurisprudence seems to be still controversial [El-Gamal 2006: 119] and there are not enough investigations on this concept in the modern partnership-based instruments in Islamic finance, it is obvious that the underdevelopment of this concept of corporate entity has been referred from the negative aspect of the premodern Islamic world, that is, this underdevelopment has been explained as an evidence of the reason why the premodern Islamic world was left in the dust of Western Europe [Greif 2005; Kuran 2003].

However, when we consider such a structural character of original partnership contracts from the macroeconomic aspect, it clarifies another implication, which is rather positive. Indeed, the underdevelopment of the concept of corporate entity restricts the continuity and extent of the relevant business. On the other hand, it also relatively limits the

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7 For example, even Zuhayli’s comprehensive commentary on Islamic jurisprudence does not have a clear explanation on the concept of corporate entity [Zuhayli 1997].
beneficiaries of the relevant business. From the macroeconomic aspect, the latter feature of original partnership contracts which lacked the concept of corporate entity implies that other economic activities are protected from the direct negative effect of the relevant business. In other words, even if the relevant business conducted by a partnership-based instrument fails, the chain of negative effects on the macro economy would be relatively moderated because those who share the risk involved in the business are limited unlike in the case of securitized products, which are characterized by successive transfer of risks. Therefore, it can be said that the original partnership contracts, which did not sufficiently develop the concept of corporate entity, have a discriminative economic feature that restrains risk scattering. The author terms this reformulated economic wisdom derived from partnership contracts as “risk-sharing without risk-scattering.”

8. Concluding Discussion: Toward New Partnership-based Instruments in Islamic Finance

How can we implement new partnership-based instruments based on the reformulated economic wisdom which is risk-sharing without risk-scattering? Generally speaking, considering the current trend of Islamic finance, it is not realistic to introduce instruments that restrict both the spatial and time-series scale of risk-sharing because, in most fields of practice, the positive effect of risk-sharing is dominant compared to the negative effect of risk-scattering. Therefore, if such instruments were to replace the existing ones, there would result in a liquidity crunch. Indeed, the mainstream proposal for improving the negative risk-scattering effect in Islamic financial practice is the enhancement of the ability to monitor and screen.

However, the economic wisdom of partnership contracts approved by the above examination has a certain degree of effect in that it reminds one of the harmful aspects of the current trend in Islamic finance, which is now replicating securitized conventional finance. Furthermore, it may lead us to casting a critical eye on this current trend of Islamic finance, which is heading toward a comprehensive financial system competitive with conventional finance. Some scholars like Mahmoud El-Gamal and Mehmet Asutay believe, if the author’s understands them correctly, that the scope of Islamic finance itself should be reconsidered. El-Gamal proposes that Islamic finance should be confined to the fields in which the substantial economic wisdom of financial instruments is realized. This implies that the other fields in which “Sharia Arbitrage” is dominant should be removed from the list of fields in Islamic financial practice [El-Gamal 2006: 174]. This proposal is rather radical, but certainly true. Rather, it may be more feasible to implement Mehmet Asutay’s proposal that Islamic finance should make strong efforts to develop the field of community banking and ethical investment [Asutay 2007: 16; 2008] (and the author
thinks that SMEs finance can be also included) because such fields seem to be so suitable size to introduce new partnership-based instruments based on the reformulated economic wisdom which is risk-sharing without risk-scattering.

People might think that such a remodeling of Islamic finance will surrender to tough capitalism. However, the experience of overseas Chinese capital in both the past and present teaches us that a corporate structure based on a robust corporate entity is not a necessary condition for economic development because Chinese business has been conducted using certain types of “risk-sharing without risk-scattering” instruments. Further, these businesses are not necessarily succeeded by the subsequent generations [Hamilton 1985]. In light of this, it can be said that both Islamic economics and Islamic financial practice should be now entering an era that will be free from the capitalistic way of thinking.

References


12


Table 1
Bank Islam Malaysia Berhad: Mode of Financing (% to Total Financing)

<table>
<thead>
<tr>
<th>Year</th>
<th>murabaha*</th>
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<th>others</th>
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*1: murabaha includes bay bi-thaman ajil

Sources: Calculated from *BIMB Annual Reports*, 1984-2006 (Data from 1984 to 1987 are cited from [Sum 1995: 95]).
Table 2
Dubai Islamic Bank: Mode of Financing (% to Total Financing)

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Sources: Calculated from *DIB Annual Reports, 1988-1995, 2001-2006* (Data from 1988 to 1995 are cited from [Dawabah 2003: 22]).
Table 3
Type of Islamic Securities in Malaysia (% to Total Issuance)

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*1: murabahah includes bay bi-thaman ajil

Sources: Calculated from Securities Commission Annual Reports, 2000-2006.