

## **Risk-Taking in Islamic Debt Financing: Maqasid Perspective**

**Muhammad Shahrul Ifwat Ishak**

*Faculty of Business and Management,  
Universiti Sultan Zainal Abidin (UniSZA), Kuala Nerus, Terengganu, Malaysia*

*shahrulifwat@unisza.edu.my*

### **ABSTRACT**

Since the past six decades of its emergence, Islamic banking industry has been widely recognized as an alternative financial system since it could offer similar services like its conventional counterpart. Islamic banking products must be free from Shariah prohibited elements, mainly riba' which is strongly forbidden. In fact, riba' is characterised with the risk absence which the risk is fully transferred to one party, resulting this practice is part of exploitation and discrimination. Alternatively, Shariah allows any financial contract as far as it is fair in terms of risk-taking among involved parties. Nevertheless, the current financings offered by Islamic banks particularly debt-based ones are claimed similar to conventional loan. Debt-based financings are systematically organized, by transferring the whole risk to customers in which it should be borne by both parties. However, others said those financings are still exposed to a certain degree of risk. Thus, this paper aims to analyse the issue of risk-taking in debt-based financing from the perspective of Maqasid shariah. This subject provides a holistic view on Shariah as well as it plays a significant role in harmonizing between revelation and reality. Based on library research, it is found that there is no strong evidence that debt-based financings should be prohibited because of the issue of risk-taking. Nevertheless, controversial practices that surrounded with those financings should be considered by Islamic finance players. While this study has limitation in terms of the data, it provides a philosophy discussion and deep analysis on the issue.

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### **INTRODUCTION**

Since the 1970s, Islamic banking industry has experienced a dramatic growth as an alternative banking to the conventional finance. In fact, the latter has dominated the global economy for almost six centuries as riba' (interest) becomes its backbone. This financial system has expanded across the world through colonization and globalization (ISRA, 2018). Since riba' is strongly prohibited in Shariah, Muslim scholars and economists had been

working hard to propose alternative banking models that based on Shariah. Eventually, in 1963 Mit Ghamr Saving Bank (MGSB) was successfully founded (Iqbal & Mirakhor, 2007). This historical success has paved the way for the establishment of Islamic banking industry, particularly in Muslim countries.

On the one hand, it is undeniable that Islamic banking industry is rapidly expanding not only in Muslim countries, but also in non-Muslim markets (ISRA, 2010). Even though many challenges faced by Islamic banking institutions such as uncondusive financial environment, restrictive civil law regulatory framework, market circumstances and insufficient human capitals, all of these have never stopped the growth of this industry. Nevertheless, on the other hand, Islamic banking has been continuously criticized by some parties due to its similar practices with the conventional banking (Chowdhury et al., 2020).

In fact, one of the striking differences between *riba'* and Shariah compliant contracts, the latter is based on risk-taking or risk-sharing, resulting they are fairer for all contracting parties (Ebrahim & Sheikh, 2016). Such contracts like *bay'* (sale), *ijarah* (hire) and *salam* (forward sale) ensure that all contracting parties must involve with a certain degree of risk through business or transactions, thus those who take or share the risk deserve to take the profit. In contrast, *riba'* manifests an exploitation because its risk is fully transferred from one party (the creditor) to another party who would bear all risks while the former is free from risk.

Over the period, many Muslim economists and scholars have encouraged *musharakah* (active partnership) and *mudharabah* (passive partnership) to be Islamic banking products, particularly as financings. Both are known as Profit-Loss Sharing (PLS) contracts as all parties share the risk involved. However, in reality, those contracts are not favourable among Islamic banks. This is due to the risk inherited from both *mudharabah* and *musharakah* for financiers (Abdul-rahman, 2017). To survive with the current financial system as well as to ensure the competitiveness of their products, Islamic banking institutions has become risk-averse like their conventional counterparts. As a result, debt-based financings are more preferable since they can secure the return for Islamic banks, as well as it can minimize the risk (Azmat et al., 2015).

In more details, contracts like *murabahah* (mark-up sale), *bay' al-Inah* (sale and buy back), *tawarruq* (to buy on credit and sell at spot value) and *ijarah* (rent) have widely dominated Islamic banking products. These contracts are argued to be controversial practices since they are not being fully applied according to classical scholars' view. *Bay' al-Inah* for example has received a fierce criticism by contemporary scholars regarding its controversial Shariah status among classical scholars (Ishak, 2019). Furthermore, its practice in Islamic banking, did not follow parameters set by classical scholars particularly it must be consisted with two separated contracts. Likewise, the *tawarruq* practice in modern banking institutions has also been criticized. Despite it is widely accepted by the majority of previous scholars, the modern *tawarruq* is organized in practice, resulting this product similar to a conventional loan (IIFA, 2009). In other words, all contracts of *bay'* in *tawarruq* are systematically arranged by the financier since its main purpose is to provide a financing, not to exchange the item as the *bay'* contract should be.

In this regard, it is worth to analyse the issue of risk absence in Islamic debt-financings from the perspective of *Maqasid shariah* (objectives of Shariah). In fact, this subject provides an insight in understanding Shariah not only from its technical rulings, but its spirit and objective. At the same time, *Maqasid shariah* plays a significant role in harmonizing between

revelation and reality by considering the *maslahah* (benefit) in human life. Since this study is a conceptual review rather than empirical research, it is based on library research method.

## **LITERATURE REVIEW**

### **Risk and Profit in Islam**

Exploring classical literature, it is learned that the subject of risk was not mentioned too much by previous scholars. This term has been known as *mukhatarah* in their works. Nevertheless, through *fiqh muamalat* (commercial jurisprudence), it is understood that the element of risk plays a significant role in determining whether a financial transaction is allowed or not. In fact, several financial practices are prohibited by Shariah because of risk issues. *Gharar* for example is forbidden based on how far it is associated with the risk. Technically, this term refers to a commercial contract that contains ambiguous elements in its substance or when the contract leads to unknown results (Saleem, 2013).

Nevertheless, in some cases, *gharar* is allowed by Shariah. For example, selling a house without looking at its foundations, and renting a house for a month, where the month can be thirty days or thirty-one days (Al-Zuhaili, 2006). This *gharar* is categorized as *gharar yasir* (minor uncertainty) due to the element of certainty is lower. This *gharar* is extremely difficult to be avoided because of the nature of the subject matter. In fact, banning this element totally could lead to difficulty in business activities. From the perspective of risk, *gharar yasir* represents a minor risk that can still be mitigated; thus, it is allowed by Shariah. In contrast, *gharar fahisy* (excessive uncertainty), in which the risk too excessive is prohibited by Shariah since it could bring harm to contracting parties when they involve in the transaction without knowing the outcome (Wan Ismail et al., 2020). Classic examples would be selling bird on the sky or fish in the river (Al-Zuhaili, 2006)

Likewise, *maisir* (gambling) is prohibited because of risk. This term refers to the easy acquisition of wealth by chance, whether or not it deprives the other's right. In financial activities, any form of business whereby the monetary gain derived from mere chance, speculation or conjecture is considered as *maisir*. These include lotteries, lotto, casino-type games and betting on the outcomes of animal races (ISRA, 2018). As mentioned in Qur'an, *maisir* is a part of the work of Satan, thus avoiding it leads to success: "*O you who have believed, indeed, intoxicants, gambling, (sacrificing on) stone altars (to other than Allah), and divining arrows are but defilement from the work of Satan, so avoid it that you may be successful*" (al-Ma'idah: 90).

*Maisir* shares a similarity with *gharar* since both contain a high risk of uncertainty that finally bring harm for involving parties. In fact, the high risk available in *maisir* makes some parties win a large amount of money, while others suffer from a huge loss (ISRA, 2015). They may end up with bankruptcy which leads to financial problems, social issues and the collapse of family institution.

On the other side, Shariah prohibits financial practices that are risk-absence. Obviously, the prohibition of *riba'* illustrates this point. This term technically means any excess compensation without due consideration (Haqqi, 2009). The element of *riba'* can be traced in a financial transaction that involves inequality of the counter-values, either through loan or sale (ISRA, 2010). In general, *riba'* can be divided into two types: *riba' al-Duyun* (loan) and *riba' al-Buyu'* (sale). The former reflects the premium that must be paid by borrowers to their lenders along with the principal amount while the latter is an inequality exchange between

riba' items as mentioned by Hadith such as gold, silver, wheat, barley, dates and salt (Al-Buti, 2005).

From risk perspective, the excess compensation through riba' is only based on time, not counter value. Thus, this increase does not relate to real economic activities, thus creditors enjoy the return without risk or loss (Furqani et al., 2014). In contrast, debtors are burdened with high risk in the repayment with additional amount than it should be. Thus, riba' reflects an unfair distribution of actual profits between lenders and borrowers. Not surprisingly, this financial practice is banned by Shariah since it leads to economic injustice or exploitation, particularly when it involves poor and greedy riches (Chapra, 2006).

Thus, imbalanced distribution of risk could be understood as among the reasons why *gharar*, *maisir* and riba' are prohibited in Islam. This element could lead to exploitation and discrimination towards contracting parties in financial transactions and economic activities. In fact, Shariah aims to ensure well-being in human life, thus any matter that leads to *maslahah* is encouraged, by contrast, a practice cause *mafsadah* (harmful) is banned. According to tafsir, when the verse of riba' has been revealed, the group of 'kafirun' (disbelievers) has questioned why riba' should be different than bay' as both aim to create the additional amount from the capital. Nevertheless, God stresses that the additional amount charged on riba' is prohibited while the profit generated from bay' is allowed (Al-Qurṭubi, 2006). In fact, riba' is considered a part of discrimination, thus its additional return is not accepted by Shariah (Shibayr, 2007a). In contrast, since the additional return through bay' is fair for all involving parties, then it is allowed as the profit.

In more details, the profit is only recognized if it does not bring harm like in riba', *gharar* or *maisir*. In this regard, there are two legal maxims to justify profit: *al-kharaj bi al-Dhoman* (profit is accompanied with responsibility) and *al-Ghunm bil al-Ghurm* (there is no return without risk) (Al-Zarqa', 2011). Both legal maxims come with a similar principle that the return or revenue comes with responsibility and liability (Laldin et al., 2013). Therefore, those who do not bear any responsibility are not entitled to any revenue. In this regard, profit should be the result of the productivity of capital that an entrepreneur has invested, or a reward for his workmanship, or for shouldering responsibility (Shibayr, 2007b). All participants in a joint business have similar rights and liabilities according to the nature of the activity, or the terms of the agreement. Essentially, Islam encourages businesses to grow by taking risk and taking part in a project without compromising the welfare of either party (Kamarulzaman & Madun, 2013).

Therefore, financial contracts like *bay'*, *ijarah*, *musharakah* and *mudharabah* are allowed because there is balanced risk-taking between contracting parties. This is due to risk-taking ensures justice in financial contracts, in form of exchange or partnership. In exchange contracts like bay', both a seller and a buyer bear exchange risks of item and money including delivery and transferring ownership (Ishak, 2018). Meanwhile in partnership contracts, even sleeping partners from *mudharabah* and *musharakah* from both contracts deserve to obtain profit since they are exposed to the risk of loss despite, they do not involve directly with work (Shibayr, 2007a).

A clear comparison can be seen between similar contracts but different condition like *wadiyah* (saving) and *wadiyah yad dhamanah* (saving with guarantee). As for the former, the custodian should not take benefit from the money because he is considered as trustee, but if the money lost not because of his negligence, he does not bear the loss. In contrast for *wadiyah yad dhamanah*, the custodian can enjoy the money because he guarantees it from lost (Laldin et

al., 2013). Similarly, a creditor in a loan contract is not allowed to take any excess since he does not bear the risk while *rab al-Mal* (capital providers) in *mudharabah* contract can enjoy the profit from the business since he bears the risk. Therefore, it can be concluded that risk-taking in financial transactions becomes the main reason to entitle the benefit and profit since contracting parties agree to bear risk and liability that are linked to real economic activities (Furqani, 2014).

### **Debt-Based Financings in Islamic Banks**

As a part of modern financial intermediaries, Islamic banks offer various types of financings for their customers. Unlike their conventional counterpart, these financings must be Shariah compliant as they must not be structured like interest-based loans. In general, there are two types of financing products offered by Islamic banks: exchange-based products and profit-sharing products.

As for exchange-based products, they involve two contracting parties which acquire ownership of asset or commodity. If contracting parties are agreed with each other, they will end up with the transfer of ownership with the exchanged counter-values (ISRA 2010). Among the contracts under this category are *bay'* and *ijarah*. Meanwhile, profit sharing products involve two or more parties who share profits as well to bear losses. Such contracts are *mudharabah* and *musharakah* (ISRA, 2010).

Over the period, exchange-based products have been widely dominated Islamic banking industry. Obviously, the emergence of *tawarruq* or commodity *murabahah* as financing has eventually made Islamic banks less innovative by over-reliant on this product (Ali, 2017). It is argued that exchange-based products which also known as debt-based products bring some advantages in terms of product development since most of them are replicated from conventional products. This replication helps Islamic banking industry to sustain its stability since replicated products are already well-established in the market (Abd Razak, 2014). At the same time, these products are claimed to be less risky for Islamic banks as well as they can overcome the liquidity shortage experienced by Islamic banks (Syed & Omar, 2017).

Nevertheless, many scholars have criticized these products as they argue profit and losing sharing should be a backbone of Islamic financings namely *musharakah* and *mudharabah*. In contrast, debt-based instruments should be limited. In other words, Islamic banks should participate actively in the operation of running the businesses or project, not as a financial intermediary or a middle party. By joining actively in the business, the profit of Islamic banks can be justified due to their involvement in risk-taking (Abd Razak, 2014). In fact, *riba'* is considered immoral since it secures a future income for lenders. Similarly, the concept of debt-based financing also secures the capital and the profit for sellers, without assuming significant market risks (Rosly & Abu Bakar, 2003).

In addition, based on the principle of risk-taking, it can be understood why many scholars have rejected *bay' al-Inah* financing facilities offered by Islamic banks in some countries. Even though *bay' al-Inah* is a part of *bay'*, it is practised through a systematic arrangement by all involving parties, resulting Islamic banks enjoy secured profit without bearing any risk or liability (Furqani, 2014). At the beginning of this product introduced in Malaysia, all transactions are documented in one process which clearly against the view of Shafi'i who allow *bay' al-Inah* (Ishak, 2019). Similarly, the case of organized *tawarruq* illustrates this point. Unlike *bay' al-Inah*, *tawarruq* has been widely accepted by classical scholars. Nevertheless, this financial practice has evolved in modern time, particularly when it has

become popular among Islamic banks. Since all parties involved are systematically organized, some scholars argued that such financing is fictitious in substance (Ahmed & Aleshaikh, 2014).

Nevertheless, many practitioners see that there should not be issues with those products or Islamic debt financings in general. In fact, Islamic banks are financial intermediary that needs efficient and profitable financings for their stability (Shahwan et al., 2013). Thus, debt-based financings should not be restricted, since there is no prohibition from the Quran and the Hadith. Moreover, there is no support from either source that Islamic financial products need to be in profit loss sharing modes (Al-Amine, 2015).

## **METHODOLOGY**

This is a conceptual study in which it applies library research approach. Through library research, available data are explored in order to achieve the research objective as well as to engage with the research problem. The data include academic works such as articles, books, proceedings as well as non-academic items like website and internet portals, then the process of analysis is conducted in a form of descriptive. Despite library research may has its limitation, it is sufficient for this study to reach its objective: to analyse the issue of risk absence in Islamic debt financings from the light of *Maqasid shariah*

## **FINDINGS AND DISCUSSIONS**

In general, *Maqasid shariah* guides mujtahid, scholars and policy makers to explore the wisdom behind Shariah rulings. In fact, Shariah should be applied along with its spirit which part of God intention through His rulings, not only literally meaning of the text of revelation. *Maqasid shariah* is combined of two words: maqasid which can be translated as objectives or purpose, while Shariah means ways, particularly it refers to Islamic laws (Al-Zaidan, 1968). Therefore, as for technical meaning of this term, *Maqasid shariah* is understood as the wisdom that is emphasized by God through His divine rulings (Al-Yübī, 1998). In other words, Shariah rulings in nature are purposive as all rulings come up with particular purposes. These purposes could either explicitly understood, or some of them can be extracted from the sources of Shariah.

Exploring the highest Shariah sources: The Quran and the Hadith, there are many verses indicate that achieving *maslahah* is the prime objective of Shariah. Such *maslahah* are realizing mercy and avoiding hardship: “And We have not sent you, (O Muḥammad), except as a mercy to the worlds” (al-Anbiya’: 107) and “Allah does not intend to make difficulty for you, but He intends to purify you and complete His favor upon you that you may be grateful” (al-Ma’idah: 6).

Meanwhile, some Shariah rulings provide particular *maslahah*. For example, the *qisas* (legal retribution) punishment aims to protecting life while *fai’* is revealed to ensure fair distribution of the wealth: “And there is for you in legal retribution (saving of) life, O you (people) of understanding, that you may become righteous” (al-Baqarah: 179) and “As for gains granted by Allah to His Messenger from the people of other lands, they are for Allah and the Messenger, his close relatives, orphans, the poor, and needy travellers so that wealth may not merely circulate among your rich.” (al-Hasyr: 7)

The element of realizing *maslahah* can also be learned from the prophetic practices such as he disapproved the idea to punish munafiqin (a hypocritical group), even though this group

brings *mafsadah* to Muslim community, punish them openly bring more *mafsadah* (Ishak, 2018a). Furthermore, considering *maslahah* was a part of policies of the Rightly Guided Caliphs. These include compiling the Qur'an in a manuscript, stopping interfaith marriage, considering three-times mentioned divorce at one time counted as three, selling any lost camel, and imposing a special fine for craftsmen if they damage their customers' property (Al-Khādimī, 2010).

In fact, *Maqasid shariah* guides those who deal with religion to consider the well-being of human beings and their current circumstance (Shinkafi & Ali, 2017). Therefore, it is crucial to avoid implementing Shariah literally, or to change its practices for the sake of satisfying human or western life (Al-Qardāwī, 2006). While *Maqasid shariah* promotes the values behind Shariah rulings instead of over-emphasising their technical legal aspect, it plays a special role in harmonising between revelation and reality. In other words, *Maqasid shariah* guides scholars to consider the change of current circumstances, human needs and customs, the social and cultural background, and the economic and political contexts, before applying any rule (Zahraa, 2003).

Based on the issue of risk-taking in Islamic banking from *Maqasid shariah* perspective, a few aspects need to be considered as the following:

1. Protection of *maal* (wealth)

Based on *Maqasid shariah*, wealth is considered one of the five *daruriyyat* (necessities) in human life that must be protected (Al-Shatibi, 2004). In fact, *maal* represents property and wealth either public or individual, in which it involves specific processes to own or to transfer among each other (Ishak, 2020). In this regard, *maal* is protected in Shariah by encouraging business activities so as it can expend for the benefit of people while to avoid *maal* from loss, several rulings are provided such as the punishment of stealing and robbery, stopping *safih* (stupid) from carrying out financial activities, and encouraging a written agreement for financial transactions (Al-Shatibi, 2004). In regards with the modern financial system nowadays, banking institutions including Islamic banks are not solely lenders or financiers. Instead, they act as a financial intermediary between two sides, taking capital from one side, and offering financing for the other side (Briscoe & Fuller, 2007). Therefore, Islamic banks must realize that their main responsibility is towards its shareholders and depositors and using their funds for a risky structure financing may jeopardize the trust of the public later, it affects the viability of Islamic banking (Dusuki, 2007).

On another aspect, even though Islamic banking industry has considerably expanded all over the world, it has been reported that few of its institutions have shut down. The Ihlal Finance House in Turkey for example was closed in 2001 because of liquidity management and financial distress (ISRA, 2010). Another example would be the case of Faisal Islamic Bank which had to close its operations in the UK for regulatory reasons (Syed Ali, 2007). Thus, it is vital to develop financing that not only compliant with Shariah, but efficient and adaptable with the current financial system as well as in line with civil laws.

2. Considering between *maslahah* in theory and *mafsadah* in practice

One of the main aspects in applying *Maqasid shariah* is to consider the consequences of action (Ishak, 2018b). In this regard with Islamic financing, in theory, it is argued that equity-based financings are fairer for contracting parties since Islamic banks and their customers bear the risk together. Nevertheless, these financings are complicated in practice due to law

restrictions. For example, home financing is the subject of the law of land that belongs to the state government as there was the case that banks could not be registered as the owner of the asset, together with their customers (Md Nor et al., 2019).

At the same time, equity-based financings are still unable to fulfil all types of financing for customers. Moreover, they are riskier, not feasible for short-term funding due to a high degree of risk, and subject to unfair treatment in taxation (Ishak, 2018). Meanwhile, if equity-based financings are not applied like its theory for example requiring customers to buy the shared asset in the case of default, how it could achieve its objective (Smolo, 2010). On top of that, there is no clear evidence from the Qur'an and the Hadith to justify that equity-based financings are more complying with *Maqasid shariah* (Bakar, 2020).

In contrast, debt-based products are in a simple form, which involves a direct relationship between bankers and customers. Moreover, debt-based financings are still considered practical solutions for Islamic banks in terms of maintaining their liquidity, as well as avoiding difficulty between customers and bankers while banning debt-based products would restrict Islamic banking products.

### 3. Removing controversial practices

In conducting their financial activities, Islamic banks must avoid negative impacts in terms of Shariah and legal aspects, regulatory impacts, economic consequences and public perception. At the same time, the authority should tighten up so-called controversial contracts, namely for *bay' al-inah* and *tawarruq*. As for the former, over the period, the Central Bank of Malaysia (BNM) has tightened the requirement of this product that it must clearly separate two contracts without the stipulated condition of repurchasing the asset (BNM, 2013). As of *tawarruq*, the latest policy issued BNM has highlighted Shariah and the operational requirements to ensure strict oversight, proper product structuring, effective risk management, sound financial disclosure and fair business and market conduct (BNM, 2018).

### 4. Embracing technology in practicing Islamic finance

It is widely accepted that the main principle in Shariah pertaining to financial and business activities: "The origin of *muamalat* is permitted unless there is evidence of the prohibition" (Al-Shatibi, 2004). Based on this principle, any contract, condition and financial dealing should be allowed as far as there is no clear prohibition from the Quran and the Hadith (Abd Latib & Izham, 2021). Therefore, Shariah opens the door of creativity and innovation broadly for humans, so as they can practice their economic activities in fulfilling their needs (Muda & Jalil, 2007). In regard to modern Islamic finance, it should be noted that the change of environment has changed financial practices in comparison to the past. For example, combining various contracts into a single product has been widely accepted by modern scholars due to its proper and secured documentation that can minimize the risk among involving parties (Abd Razak, 2016).

Furthermore, with modern financial technology, any financial contract can be easily executed in a systematic and prompt way. For example, transferring ownership can be carried out through an electronic system that can save time. This development in fact has contributed to the efficiency of Islamic finance particularly in facilitating its instrument that is more complex in comparison with conventional instruments. As a result, Islamic financial products are more competitive. Even though with technology, financings in Islamic banking industry that utilize Shariah-compliant contracts are still exposed to legal and Shariah non-compliant

risks. Such risks are due to the exchange process, transferring ownerships, electronic system, and product documentation. Therefore, practicing contracts in a systematic way does not go against Shariah rulings. From the perspective of *Maqasid shariah*, if this practice leads to support the viability of Islamic banking industry without compromising Shariah elements, then it should be accepted. Furthermore, Islamic banks should emphasize on providing the quality of services and products for the sake of their viability (Yusof & Ismail, 2020).

## CONCLUSION

This paper analyses the issue of risk-taking through Islamic debt-based financings. Since the majority of Islamic financings is in the form of debt, they are systematically organized and structured to ensure the efficiency of practices. As a result, some parties argue that there is no difference between Islamic and conventional products as both are risk-absence. Based on *Maqasid shariah*, protecting *maal* is considered among the highest objective of Shariah. Since Islamic banks are part of financial intermediary, they must be responsible for the fund of their depositors and shareholders, as utilizing their fund must avoid unnecessary risks. At the same time, it is argued that equity-based financings are difficult to be applied in reality, while there is no evidence that they are preferable in comparison to debt-based financings. Nevertheless, controversial practices on some debt products like *bay' al-Inah* and *tawarruq* need to be removed. Lastly, embracing technology for the sake of efficiency of Islamic finance practice should be supported, particularly if it can ensure the viability of Islamic banks. All in all, this study provides a philosophy discussion and deep analysis on the issue from *Maqasid syariah*. Nevertheless, since it is based on library research, its data is limited. Thus, future studies are suggested to expand this issue into empirical research.

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