



**DETERMINANTS OF MAQASID
AL-SHARI'AH-BASED PERFORMANCE
MEASUREMENT PRACTICES: THE CASE OF
MALAYSIAN ISLAMIC BANKS**

BY

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ABSTRACT

Islamic banking has emerged as a thriving industry because demand is increasing in both developed and developing countries including Malaysia. Islamic banks serve Muslim and non-Muslim communities with interest-free financial products and services. The development of Islamic banks should be in tandem with their contributions to achieve the objectives of Islamic law (*Maqasid al-Shari'ah*). *Maqasid al-Shari'ah* should form an integral part of the strategies underpinning the development of the Islamic financial system. However, the growth of Islamic banks is being challenged as they are not able to achieve *Maqasid al-Shari'ah*. It is argued that the failure to achieve *Maqasid al-Shari'ah* is caused by the weakness of the Performance Measurement System (PMS) of the banks. The key role of a PMS is to provide a link between business strategies and organizational objectives. Thus, the PMS of Islamic banks must be adapted to align with *Maqasid al-Shari'ah*. This study aims to explore the performance measurement practices in Malaysian Islamic banks based on *Maqasid al-Shari'ah*. The study also examines the differences between the two types of Islamic bank in Malaysia, namely, full-fledged Islamic banks and Islamic banking subsidiaries, in terms of *Maqasid al-Shari'ah*-based performance measures and organizational performance. To gather data for this study, the researcher distributed 146 questionnaires to various participants from head officers to senior managers in each department/business unit of all 16 Islamic commercial banks in Malaysia. The results indicate that only technological advancement and regulatory compliance have a direct relationship with the *Maqasid al-Shari'ah*-based performance measures. In addition, the results also indicate that having *Maqasid al-Shari'ah*-based performance measures would enhance the organizational performance of Islamic banks. The results also reveal that a differentiation strategy, technological advancement, innovativeness, and regulatory compliance bring about greater interdependence on the *Maqasid al-Shari'ah*-based performance measures, which induces improved organizational performance in Islamic banks. This study also found that financial and non-financial measures as well as performance measures based on the *Maqasid al-Shari'ah* framework are equally important and are being implemented in Islamic banks in Malaysia. However, the findings show that there are significant differences in terms of *Maqasid al-Shari'ah*-based performance measures as well as organizational performance for both types of Islamic bank. Therefore, this study contributes to the performance measurement literature on *Maqasid al-Shari'ah*-based performance measures in the context of Islamic banks

ملخص البحث

يعتبر المصرف الاسلامى احدى الصناعات المزدهرة وبذلك الطلب على السوق المالى الاسلامى فى تزايد فى الدول المتقدمة والنامية بما فى ذلك ماليزيا. المصارف الاسلامية تقدم خدمات و منتجات بدون فوائد مالية للمجتمع الاسلامى وغير الاسلامى. تطوير البنوك الاسلامية ومساهمتها يجب ان يكون من ضمن اهداف الشريعة الاسلامية. مقاصد الشريعة يجب ان تكون جزء مهما للتطوير النظام الاسلامى المالى. كما أن التنمية السريعة والتحديات التي تواجه البنوك الاسلاميه قد منعتها من تحقيق مقاصد الشريعة. ومن بعض الاسباب التي ادت إلى فشل البنوك الاسلاميه هو الضعف في عملية اداء قياس النظام الاسلامى فى البنك لان الدور الاساسى من عملية اداء قياس النظام الاسلامى هو ربط الخطط الاستراتيجية مع اهداف المنظمه وبالتالي فإن طرق قياس الاداء فى البنوك الاسلامى لا بد أن تُستخدم وتُطبق من أجل تحقيق مقاصد الشريعة. تهدف هذه الدراسة إلى استكشاف طرق قياس الأداء فى المصارف الإسلامية. بماليزيا من خلال التحقيق فى تأثير تنوع قياس الأداء ومحدداتة على أداء التنظيمى للمصارف الإسلامية. أيضا, هذه الدراسة تهدف للاختبار مدى استعابة قدرة البنوك الإسلامية فى النظر الى إطار قياس بمقاصد الشريعة بطرق قياس أدائها بالإضافة إلى قياس الأداء الشامل. قام الباحث بتوزيع 146 استبيان فى تنفيذ هذا البحث. هذه الدراسة سوف تشمل كل من رؤساء الاقسام/كبار المديرين فى كل وحدة إدارية/عمل فى جميع البنوك الإسلامية بماليزية (16 إسلامك بنك). تشير النتائج إلى أن التقدم التكنولوجى والامثال التنظيمى فقط لهما علاقة مباشرة مع تنوع مقاييس الأداء. ايضا, اتضح ان اختلاف فى استراتيجية و التقدم التكنولوجى و الابتكار و الامثال التنظيمى يعتمد على بدرجة كبيرة على تنوع مقاييس الأداء و بالتالى تودي الى تحسين الأداء التنظيمى فى البنوك الإسلامية.بالإضافة, فيما يتعلق باطار مقاصد الشريعة و مقاييس الأداء المالية/غير المالية, وجدت هذه الدراسة ان لهما نفس درجة الاهمية فى استعمالها بالمصارف الإسلامية. بالإضافة إلى ذلك, تظهر النتائج أن هناك درجة كبيرة من الاختلاف من حيث تنوع مقاييس الأداء وكذلك الأداء التنظيمى بين انواع المصارف الإسلامية ولا سيما المصارف الإسلامية الكاملة و المصارف الإسلامية التابعة للمصارف التقليدية. أخيراً, وجدت هذه الدراسة أن تقنية الميزانية تعتبر من اهم الطرق للادارة فى البنوك الإسلامية للقياس الأداء. البحث يساهم فى إثراء خزانة الدراسات عن قياس الأداء بدراسته القياس المتبنى على نظرية مقاصد الشريعة فى إطار المصارف الإسلامية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigative research work, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions of higher learning.

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LIST OF ABBREVIATIONS

BSC	Balanced Scorecard
CSR	Corporate Social Responsibility
IFIS	Islamic Financial Institutions
IBS	Islamic Banking Systems
IT	Information Technology
KPI	Key Performance Indicators
MAS	Management Accounting System
MCS	Management Control System
PMS	Performance Measurement Systems
PCA	Principal Components Analysis
ROA	Return on Assets
ROE	Return on Equity
SAC	Shari'ah Advisory Council
SBU	Strategic Business Unit

CHAPTER ONE

INTRODUCTION

1.0 INTRODUCTION

This chapter consists of five sub-sections. Section 1.1 explains the background of the study. Section 1.2 discusses the problem statement of the study. Section 1.3 outlines the motivation of the proposed study. Section 1.4 states the research objectives and research questions of the study. Finally, section 1.5 concludes with a brief explanation of the structure of the study.

1.1 BACKGROUND OF THE STUDY

The rapid growth of the Islamic banking industry as an alternative to conventional banking in both developed and developing countries has become a pertinent issue among researchers globally. Islamic banking is a system of banking that complies with *Shari'ah* (Islamic law) and possesses its own characteristics and objectives. The uniqueness of the basic principles controlling Islamic banking lies in the mutual risk and profit sharing between contracted parties (Dusuki & Abdullah, 2007; Khan, 2010) and the assurance of fairness in all activities (Iqbal & Mirakhor, 2007). These principles are supported by the core values of Islamic banking, which include activities that promote entrepreneurship, trade and commerce, as well as produce societal development.

Islamic banking practices are based on the fundamentals of Islamic economic values (Khan & Mirakhor, 1989) whereby all activities and operations should be aligned with Islamic teaching. In Islamic economic systems, every economic activity must be initiated in order to achieve *Maqasid al-Shari'ah* (objectives of Islamic law).

According to Siddiqi (2006), *Maqasid al-Shari'ah* is considered a core value in Islamic economic systems, especially for Islamic banking and finance, because it covers all aspects of life and preserves the individual and public *maslahah* (interest). Hence, the Islamic banks should currently emphasize in achieving *Maqasid al-Shari'ah* in every aspect of its operations. The issue has even received attention and support from governments, especially in Malaysia. Recently, Malaysia has become a pioneer in the establishment of an international *Maqasid al-Shari'ah* index for Islamic banking and takaful (insurance) (Zakaria, 2014). Nevertheless, the empirical evidence showing Islamic banks supporting *Maqasid al-Shari'ah* is sparse.

The growth and development of Islamic banks is also dependent on some internal and external factors. Similar to other service industries, they may be affected by changes in the business environment. Thus, service industries should be more aggressive in offering the right quality services at the right time and price (Mohd Amir *et al.*, 2010). It is believed that strategies such as developing an effective performance measurement system (PMS) could help Islamic banks response to the internal and external changes affecting the industry. A PMS refers to a system that could provide information to an organization in order to identify the strategies that would have the highest potential to achieve the organization's objectives (Brignall & Ballantine, 1996; Chenhall & Langfield-Smith, 1998; Ittner *et al.*, 2003; Tung *et al.*, 2011). The diverse information provided by a PMS is used for organizational control and for achieving organizational goals, as well as enhancing organizational performance (Baines & Langfield-Smith, 2003; Chenhall & Langfield-Smith, 2007; Mia & Clarke, 2001).

In the context of Islamic banks, performance measurement practices should not only cover financial and non-financial measures, but also must cover all aspects

related to the core values of *Maqasid al-Shari'ah*. Even though the performance measures based on the *Maqasid al-Shari'ah* framework have been discovered by Mohammed *et al.* (2008), the impact of these measures has not yet been tested in relation to the organizational performance of Islamic banks. Hence, performance measurements that are related to comprehensive performance measures as well as *Maqasid al-Shari'ah* performance measures need to be assessed in order to discover if they are of any benefit to the organizational performance of Islamic banks. Therefore, the performance measurement practices in Islamic banks in Malaysia would be an interesting issue to investigate. In general, this study aims to investigate the determinants of performance measurement practices, various types of performance measures (comprehensive performance measures and *Maqasid al-Shariah* measures) and organizational performance of Islamic banks in Malaysia.

1.2 PROBLEM STATEMENT

Contingency perspective espouses that the performance measurement practices differs according to the type of organization and the nature of its operations. Every single industry, whether manufacturing, services or construction, has its own nature and unique characteristics. Thus, the results of previous works show that the nature of use, influencing factors and tools of financial performance measures and the relations between them vary depending on the industry studied.

In the case of an Islamic banking industry, the objectives of Islamic banks should be aligned with *Maqasid al-Shariah*. However, Islamic banks in Malaysia are currently facing challenges in achieving *Maqasid al-Shari'ah*. Also, the financial performance of Malaysian Islamic banks in accordance with the *Maqasid al-Shari'ah* framework was ranked in fifth place as compared to other international Islamic banks

such as Islami Bank Bangladesh and Bahrain Islamic Bank and Islamic International Arab Bank (Mohammed, 2008). In addition, Mohammad and Shahwan (2013) argue that Islamic banking should promote *Maqasid al-Shari'ah* in Islamic banking operations because it has been found that the objectives of Islamic banks are mostly aimed towards achieving success as a profit-oriented entity rather than a social-based entity. Therefore, the performance measurement practices in Islamic banks should not only be aimed at achieving organizational profit and sustainability, but performance measurement practices must incorporate Islamic banking objectives and characteristics.

Besides, Mohamed (2010) states that performance measurement practices have been implemented in Islamic banks in order to measure the diversity of financial and non-financial performance dimensions. Most of the prior research in Malaysia has been conducted to measure the organizational performance of Islamic banks by using financial performance ratio measurements. However, studies on the performance management practices of Islamic banks in Malaysia are sparse. Also, there is insufficient information on the extent to which Islamic banks measure their organizational performance through a diversity of performance measures, especially performance measures based on the *Maqasid al-Shari'ah* framework as suggested by Mohammed *et al.* (2008). These multidimensional performance measures could provide Islamic banks with comprehensive performance indicators to enhance organizational performance as well as achieve *Maqasid al-Shari'ah*. Failing to incorporate *Maqasid al-Shari'ah* in the PMS system would cause Islamic banks to abandon the original aims that were established for the benefit of Muslim ummah.

1.3 MOTIVATION OF THE STUDY

Performance measurement practices in Islamic banking have also received considerable attention from management accounting scholars, especially in Malaysia. For instance, Mohammed *et al.* (2008) propose a new model of performance measurement to evaluate whether the financial performance of Islamic banks is in line their objectives based on the *Maqasid al-Shari'ah* framework. Since Islamic banking is struggling to achieve *Maqasid al-Shariah*, the proposed model could provide some insights into how banks can manage their performance on the basis of the *Maqasid al-Shari'ah* framework.

In relation to growing globalization, Islamic banks should be able to face the many challenges in today's competitive market. In the case of Malaysia, the establishment of Islamic subsidiaries by conventional banks has led to a more competitive environment because the banks have to compete with well-established full-fledged Islamic banks to gain market share. Hence, Islamic banks should be able to adopt and implement comprehensive performance measures as well as *Maqasid al-Shari'ah*-based performance measures to cater to the problems that they may encounter in competing in today's globalized business environment. Prior studies have indicated that the two types of bank are different in terms of the sources of capital contribution (Sole, 2007), customer preferences (Osman *et al.*, 2009) and efficiency (Abdul-Majid & Hassan, 2011) as well as in the extent of their experience of Islamic banking operations. Therefore, the variety of performance measures as well as differences in the organizational performance of the two types of Malaysian Islamic bank would be an interesting topic of research because they have different characteristics.

1.4 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS

The main objective of the study is to enhance knowledge and understanding of the performance measurement practices in Islamic banks in Malaysia. The following specific objectives are identified in order to conduct this study:

1. To investigate the direct relationship between the determinants of performance measurement practices and *Maqasid al-Shari'ah*-based performance measures of Malaysian Islamic banks;
2. To investigate the direct relationship between *Maqasid al-Shari'ah*-based performance measures and organizational performance;
3. To investigate the indirect relationship between the determinants of performance measurement practices and organizational performance through *Maqasid al-Shari'ah*-based performance measures;
4. To examine the differences between the two types of Islamic bank in Malaysia (full-fledged Islamic banks and Islamic banking subsidiaries) in terms of *Maqasid al-Shari'ah*-based performance measures and organizational performance.

Therefore, based on a review of the literature on the current issues related to the PMS, the following main research questions are considered appropriate to achieve the above objectives:

1. Is there any direct relationship between the determinants of performance measurement practices and *Maqasid al-Shari'ah*-based performance measures?
2. Is there any direct relationship between *Maqasid al-Shari'ah*-based performance measures and organizational performance?

3. Is there any indirect relationship between the determinants of performance measurement practices and organizational performance through the *Maqasid al-Shari'ah*-based performance measures?
4. Is there any significant difference between full-fledged Islamic banks and Islamic banking subsidiaries in terms of *Maqasid al-Shari'ah*-based performance measures and organizational performance?

1.5 STRUCTURE OF THE STUDY

The study is organized into six chapters. Chapter one briefly discusses the background of the study, research problem, motivation, and research objectives and research questions of the study.

Chapter two reviews the literature on the characteristics of Islamic banking systems. It also outlines the objectives of Islamic banks according to *Maqasid al-Shari'ah* PMSs and development of Islamic banks in Malaysia. In addition, it provides a brief discussion of the definition of a PMS and its roles on organizational development. Then, the chapter also discusses PMS and organizational performance in various countries in distinct types of organization. Finally, it explains the performance of Islamic banks in Malaysia.

Chapter three presents the theoretical framework and hypotheses development of the study. The contingency theory applies in this study and discusses in this chapter. Then, the hypotheses are developed to investigate the relationship between the variables of the study.

Chapter four explains the research methodology of the study including the research design, sample selection, data collection procedures and measurement of the

variables. Furthermore, the pilot test and the types of statistical tests used in this study are also presented in detail.

Chapter five describes the analysis and findings of the study. Finally, chapter six concludes the study by discussing the main findings and the contribution of the study. The limitations of the current study and suggestions for future research are also discussed in this chapter.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

This chapter is organized as follows: Section 2.1 discusses the literature on the Islamic banking system. Section 2.2 discusses the literature on Islamic banks in Malaysia and their governance. Section 2.3 discusses the literature on the role of the PMS in organizational development. Section 2.4 discusses the literature on various types of PMS. Section 2.5 discusses the literature on the PMS and organizational performance. Section 2.6 discusses the literature on the PMS in the service industries. Section 2.7 discusses the literature on the performance of the banking industry in Malaysia. Finally, section 2.8 identifies the gaps in the literature and concludes the chapter.

2.1 THE ISLAMIC BANKING SYSTEM

2.1.1 Characteristics of the Islamic Banking System

Since its emergence, Islamic banking has not just been considered as a business entity that aims only to fulfil the religious needs of the Muslim community, but more significantly, as a business that undeniably needs to attract customers including those from non-Muslim communities. According to Iqbal and Mirokhar (2007), researchers in the field of Islamic economics have highlighted some of the outstanding features of Islamic banking and finance that make it distinctive and unique from conventional banking, which includes striving for a just, fair and balanced society.

Islamic banks run their business in a different way in terms of operations, characteristics and objectives compared to conventional banks. The main reason for this difference is that the Islamic banking system is based on *Shari'ah* (Islamic law).

Dusuki and Abdullah (2007) argue that the rationale behind the emergence of an Islamic banking system is not only about restricting and conforming to provisions under *Shari'ah* in offering Islamic financial products, it is also a system that aims to fulfil the socioeconomic objectives of society. Islamic banks that operate under an Islamic economic system consider that the socioeconomic condition of society is also important in order to take account of to establish fair economic development.

Under *Shari'ah* rules and principles, Islamic banks are prohibited from being involved in any contract that deals with *riba* (interest). For instance, they are prohibited in Islam from providing interest-based products for their customers. The term *riba* is literally understood as 'an increase' from the Islamic perspective. It is clearly stated in the Holy Quran that: "Allah has permitted trade and has forbidden interest" (Al-Quran, 2:275). It is commonly understood in this context that this refers to all predestined interest payable on a loan of any kind. Similarly, *riba* has been defined by Rosly and Abu Bakar (2003) as "a contractual increase arising from a *qard* (loan), whether in money or barter". According to *Shari'ah*, *riba* is forbidden because it leads to the concentration of wealth in the hands of the few (Mirza & Baydoun, 2000).

Thus, some Islamic banking products involve an equity contract rather than a debt-based contract (Dusuki & Abdullah, 2007; Khan, 2010). The system of equity contracts operates on the principle of a variable return based on the actual productivity and performance of the projects, specific or general, individual or institutional, private or public. The contracts that are implemented under this system include partnership contracts, *mudharabah* and *musharakah*, in which each party involved shares the profit and loss according to the agreed ratio as stated in the contractual agreement.

Debt-based transactions are prohibited in Islamic banking because they are similar to the loan-interest relationship in conventional banking.

Moreover, the Islamic economic system prohibits *gharar* (uncertainty), *maysir* (gambling) or anything that could lead to the wrongful enhancement or unjust abuse of one of the parties to the contract. *Gharar* could be defined as anything where the consequences are hidden (Darir, 2012). It also might refer to any transaction of possible items where their existence or characteristics are not convincing, which might be because of lack of knowledge, either party's ignorance about vital elements in the transaction, or inconclusiveness regarding the ability of one party to honour the contract. In addition, Tahir and Brimble (2011) argue that *gharar* is seen as akin to gambling.

The forbiddance of *gharar* in Islam is based on the concept of justice and equitable dealing. This is because any transaction that involves *gharar* may result in the repression or unfair treatment and loss of properties of one or even both parties (ISRA, 2011). *Gharar* is prohibited in Islam so as to protect the parties involved in a business contract from deceit, ignorance and uncertainty. According to Abdullah (2012), Islam clearly prohibits all unjust business transactions in any form among any of the parties involved in business. Unjust dealings might lead to ambiguity, deception, fraud or unreasonable advantage. Moreover, a contract may not be valid without the full agreement of the parties involved. Therefore, the prohibition of the element stated is important in ensuring that there is full agreement and contentment among all the parties in a contract.

Furthermore, the Islamic banking system places emphasis on a high level of ethical and moral conduct in its business activities and transactions. Dealing with *haram* (unlawful) and unethical behaviour such as gambling (Abdel-Majid & Hassan,