

THE SCOPE OF REWARD AND RISK IN ISLAMIC
FINANCE: AN APPLICATION TO MALAYSIAN
BANKING PRACTICE

BY

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ABSTRACT

The problem investigated by this study is the lack of dedicated discussion on the parameters of reward and risk according to their normative definitions in Islamic finance. Hence, this study will attempt to define those parameters as they are presented in the literature. Furthermore, an application of such parameters will be conducted on selected Islamic banking products as they are practiced in Malaysia to judge the causes of compliance or non-compliance and propose new theoretical definitions for the parameters of reward and risk to allow for flexibility and ensure greater compliance. The study begins with a qualitative analysis of the literature to establish the current definitions of reward and risk and then reviews industry practice through industry literature such as product disclosure sheets and regulator policy documents to judge embodiment of such parameters or lack thereof with respect to these products in the Malaysian Islamic banking practice. Further critical qualitative analyses will be conducted to explore the purpose of compliance or non-compliance to the reward and risk parameters and finally propose new parameters to harmonize the normative parameters with industry practice. The most important findings are that first, the normative of reward and risk are one, financing transactions need to comply to ownership, market and capital loss risk requirements, observe 'other' risk requirements, equitable sharing of costs, feature value-adding, and finally comply with conditions of financing using capital. In judging the practice, it is concluded that conformity to the reward-risk parameters is only done in form and not in substance in the Malaysian Islamic banking financing products context. The alternative parameters which are considered by the practice *maqasid*, prevalent financial intermediation model, the consideration for excessive reward and risk, needs and necessities. The justifications for the alternative parameters are the parameters of reward and risk are susceptible to alternative interpretations which has been demonstrated at the end of the findings. This study recommends that a proper adaptive framework be developed by standard-setter which helps standardize the embodiment of the spirit of Islamic finance such as elements of equity through reward-risk instead of merely focusing on enforcing rigid structural rules.

خلاصة البحث

المشكلة التي تستكشف في هذه الدراسة هي عدم وجود دراسة مخصصة بتحديد الضوابط المعيارية للمخاطر والمكاسب في المالية الإسلامية. وبالتالي، تحاول هذه الدراسة تحديد تلك الضوابط. بالإضافة، يتم تطبيق هذه الضوابط على منتجات مصرفية إسلامية مختارة كما تجرّيها البنوك الإسلامية الماليزية للحكم على موافقة أو عدم موافقة الممارسات لتلك الضوابط المحددة، وكذلك ستقترح ضوابط نظرية جديدة للمخاطر والمكاسب تتصف بالمرونة وتسمح لممارسات القطاع أن تكون موافقة أكثر للضوابط. تبدأ الدراسة بتحليل وصفي للدراسات السابقة لإثبات الضوابط المقررة حالياً للمخاطر والمكاسب، وبعد ذلك تراجع ممارسات قطاع المالية الإسلامية من خلال الدراسات والوثائق التي ينتجها أو يصدرها القطاع مثل وثائق بوليصة البنك المركزي واستمارات الإفصاح عن المنتج (PDS) للبنوك الإسلامية الماليزية، ويستمر مراجعة الدراسات التي تناقش ممارسات قطاع الصيرفة الإسلامية في ماليزيا. علاوة على ذلك، ستقوم الدراسة بتحليلات وصفية نقدية لاستكشاف سبب موافقة هذه الضوابط للممارسات القطاع لهذه الضوابط أم عدم ذلك، وأخيراً لاقتراح ضوابط جديدة للتوفيق بين الضوابط المعيارية المقررة وممارسات قطاع الصيرفة الإسلامية الماليزي. أهم النتائج التي توصلت إليها الدراسة هي أولاً، أن الضوابط المعيارية تتمثل في ضرورة تحمل المخاطر المتعلقة بعملية التمويل من قبل الأطراف المتعلقة بما في ذلك من مخاطر والمكاسب هي مخاطر الملكية، مخاطر خسارة الرأسمال، ومخاطر السوق؛ ثانياً، المساواة في تحمل تكاليف عمليات التمويل؛ ثالثاً أن تكون عمليات التمويل مضيئة للقيمة (-value adding). خلاصة مراجعة ممارسات قطاع الصيرفة الماليزي أن الضوابط المعيارية متبعة شكلياً دون جوهرها ومقصدها. الضوابط البديلة التي اقترحتها الدراسة والتي تراعى في قطاع الصيرفة الإسلامية في ماليزيا هي اعتبار المقاصد المخاطر والمكاسب، النموذج السائد للوساطة المالية محلياً ودولياً، مراعاة المبالغة أو الفحش في المخاطرة والكسب أو الاسترباح، ومراعاة الحاجيات والضروريات. تبرير مراعاة هذه الضوابط البديلة هو أن ضوابط المخاطر والمكاسب مرنة وأنها النصوص الشرعية التي انبنت عليها تخضع لتأويلات مختلفة كما أثبت ذلك في نهاية قسم النتائج. تقترح هذه الدراسة على المنظمين وواضعي المعايير لقطاع المالية الإسلامية تطوير إطار مرن يعرعى مصادق المالية الإسلامية في المخاطرة والكسب.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

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Supervisor

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, 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.

Mohamed Benaicha

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This dissertation is dedicated to Allah Almighty, my parents, siblings, teachers, and friends for laying the foundation of what I turned out to be in life. I also dedicate to my very supervisor who is has been a most excellent mentor like the other people at IiBF.

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TABLE OF CONTENTS

Abstract.....	ii
Abstract in Arabic.....	iii
Approval Page.....	iv
Declaration.....	v
Dedication.....	vii
Acknowledgement.....	viii
List of Tables.....	xi
List of Figures.....	xii
List of Abbreviations.....	xiii
CHAPTER ONE: INTRODUCTION.....	1
1.1 Background of the Principle of Reward and Risk.....	1
1.2 Research Problem.....	4
1.3 Research Objectives.....	7
1.4 Research Questions.....	7
1.5 Scope of the Research.....	8
1.6 Significance of the Research.....	8
1.7 Chapterization.....	9
CHAPTER TWO: LITERATURE REVIEW.....	10
2.1 Introduction.....	10
2.2 Background and Concept of Reward and Risk.....	10
2.3 Criticism of the Reward-Risk Principle in General Islamic Banking Practice.....	15
2.4 The Application of Reward-Risk in Selected Contracts.....	18
2.4.1 Murabahah to the Purchase Orderer (MPO).....	19
2.4.2 Al-Ijarah Thumma Al-Bay' (Aitab).....	22
2.4.3 <i>Musharakah Mutanaqisah</i> Partnership (Mmp).....	26
2.5 Contemporary Islamic Legal Theories.....	30
2.5.1 Theory of Multi-Dimensionality (<i>Ta'addudīyah Al-Ab'ād</i>).....	30
2.5.2. Hierarchy of Objectives and Its Evolution (<i>Marātib Al-Maqāṣid</i>).....	31
2.5.3. The Theory of Varying Means and Definitive Ends (<i>Taghayyur Al-Wasā'il Wa Qaṭ'īyah Al-Ma'ālāt</i>).....	32
2.5.4. The Centrality and Universality of Revelation (<i>Markaziyyah Wa 'Alamiyah Al-Wahy/Al-Nusus</i>).....	32
2.6 Literature Gap.....	33
2.7 Conclusion.....	34
CHAPTER THREE: METHODOLOGY.....	36
3.1 Design of the Research.....	36
3.2 Conceptual Framework.....	37
3.3 Research Methods.....	41
3.4 Data Analysis.....	42

CHAPTER FOUR: FINDINGS	43
4.1. Introduction.....	43
4.2. The Concept of Reward and Risk in Islamic Finance.....	43
4.2.1. Risk (<i>Ghurm</i>)	48
4.2.2. Other Risks.....	53
4.2.2.1 Dhaman and Risk	55
4.2.3. Costs and Reward-Risk.....	55
4.2.4. Work, Effort (<i>'Amal</i>) and Value-Added	58
4.2.5. Capital (<i>Mal</i>).....	61
4.3 The Malaysian Banking Practice	65
4.3.1. <i>Murabahah</i> to the Purchase Ordered (MPO) Practice	67
4.3.2. <i>Al-Ijarah Thumma Al-Bay'</i> (AITAB) Practice.....	73
4.3.3. <i>Musharakah Mutanaqisah</i> Partnership (MMP) Practice	80
4.4 Proposed New Parameters of Reward-Risk for Selected IB Products.....	86
4.4.1 Higher Parameters of Reward-Risk	87
4.4.1.1 Shari'ah Objectives Concerning Reward-Risk.....	88
4.4.1.2 Shari'ah Utilities (Masalih) Concerning Reward-Risk	92
4.4.2 Revisiting The Shari'ah Sources' Stance on Reward-Risk.....	98
4.5 Summary of Findings.....	107
 CHAPTER FIVE: CONCLUSION AND RECOMMENDATIONS	109
5.1 Conclusion	109
5.2 Recommendations.....	111
 REFERENCES	113
 APPENDIX 1: SAMPLE OFFER LETTER FOR MM HOME FINANCING	128
APPENDIX 2: HISTORY AND UNIQUE CHARACTERISTICS AITAB	134

LIST OF TABLES

Table 4.1	Summary of the normative parameters of reward-risk	62
Table 4.2	Reward-risk parameters of MPO in Malaysian IB practice	67
Table 4.3	Reward-risk parameters of AITAB in Malaysian IB practice	73
Table 4.4	Reward-risk parameters of MMP in Malaysian IB practice	80
Table 4.5	Higher and component parameters of reward-risk in Malaysian IB practice	96
Table 4.6	Shari'ah texts relating to reward-risk	99
Table 4.7	Current and alternative interpretations of texts concerning reward-risk Parameters	105

LIST OF FIGURES

Figure 2.1	Reward-risk application to the MPO	21
Figure 2.2	Reward-risk application to AITAB	26
Figure 2.3	Risk reward application to MMP	29
Figure 3.1	Reward-risk Parameters Currently established in the literature	38
Figure 3.2	Elements of reward-risk in the selected IB financing products	38
Figure 3.3	Appraisal of the elements of reward-risk in the MPO, AITAB and MMP in the Malaysian IB practice	40
Figure 3.4	Process for redefining the parameters of reward-risk in the Malaysian IB practice	41
Figure 4.1	Flowchart of the normative parameters of reward-risk	64
Figure 4.2	New reward-risk parameters for the selected Malaysian IB financing products	104

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organizations of Islamic Financial Institutions
AB-i	Accepted Bill-Islamic
AITAB	<i>Al-ijarah thumma al-bay'</i>
BBA	<i>Bay' bi thamanin ajil</i>
BNM	Bank Negara Malaysia
FT	Fire <i>Takaful</i>
IAH	Investment account holders
IATAM	<i>Al-ijarah al-muntahiyah bi al-tamlik</i>
IB	Islamic banking
IDB	Islamic Development Bank
IF	Islamic finance
IFI	Islamic financial intermediary
IFS	Islamic financial system
IIFA	International Islamic Fiqh Academy
IRTI	Islamic Research and Training Institute
HP	Hire-Purchase
MMP	<i>Musharakah mutanaqisah</i> partnership
MPO	<i>Murabahah</i> to the purchase orderer
MT (MRTT)	Mortgage Reducing Term <i>Takaful</i>
PD	Policy Document
PDS	Product Disclosure Sheet
PLS	Profit-and-loss sharing
PS	Profit sharing
PSR	Profit sharing rate
SAC	Shariah Advisory Council (of BNM)
SG-i	Shipping Guarantee-Islamic
SIP	Structured investment product
TR-i	Trade Receipt-Islamic

COMMON ABBREVIATIONS

app.	appendix	n.p.	no place: no publisher
art./ar	article/articles	no./no.s	number/numbers
ts. b.	born	n. s.	new series
bk./bks.	book/books	o. s.	old series
P. B. U. H.	Peace Be Upon Him		
c.	copyright		
ca.	(circa): about, approximately		
cf.	compare	p./pars.	paragraph/paragraphs
ch.	chapter (in legal firms)	passim	here and there
chap./chaps.	chapter/chapters	pt./pts.	part/parts
col./cols.	column/columns	q. v.	(<i>quode vide</i>): which see
comp./comps	compiler/compiler;	sc.	scene
.	compiled by		
dept./depts.	department/departments	sec./secs.	section/sections
d	died		
S. W. T.	Subhanahu Wa Ta'ala (Praise be to Allah and the Most High)	sic.	so, thus
div./divs.	division/divisions	s. l.	(<i>sinoloco</i>): no place of publication
e. g	(<i>exempligratia</i>); for example	s. n.	(<i>sine nomine</i>): no publisher
ed./eds.	edition/editions; editor, edited by	s. v.	(<i>sub-verbo, sub-voce</i>) under the word of heading
et al.	(<i>et alia</i>): and others	trans.	translator/translated by
et seq	(<i>et sequers</i>): and the following	v./vv.	verse/verses
etc	(<i>et cetera</i>): and so forth pages that follow	viz.	(<i>videlicet</i>): namely
fig./figs.	figure/figures	vol./vols.	volume/volumes
ibid.	(<i>ibidem</i>): in the same place		
id	(<i>idem</i>): the same below		
L. E.	Law of Evidence		
l. v.	(<i>locus variis</i>): various places (of publication)		
ms./mss.	manuscript/manuscripts		
n. d.	no date		

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE PRINCIPLE OF REWARD AND RISK

In Islamic finance (IF), several key principles form the foundation and spirit of entire system of economic activity. It is well-established that the economizing problem in IF is not in production but rather in distribution – and redistribution. Considering that Allah Almighty has created enough resources on earth to sustain humanity, and that humanity consumes those resources based on their limited needs and not based on their unlimited wants and luxuries, the problem remains of how wealth that is produced is distributed amongst transactors. Although the Shari’ah has allowed for varied means of distribution through different arrangements as is the scholarly consensus, all such arrangements must embody a common set of principles and of special importance and relevance to the research is the principle of equitable distribution of income and wealth. Chapra (1985) necessity of this principle in financing.

The *riba*-based system is known to distribute wealth unequally favoring the rich capitalist over the poor borrower, an observation repeatedly made by Usmani (2000) and emphasized by numerous other experts. Such social injustice was prevalent during the time when the verses prohibiting *riba* were revealed upon the Holy Prophet (al-Qasir, 2016). The Islamic alternative is the prohibition of interest and imposition of basic mechanisms of entitlement of fair earnings, alternatively dubbed as the Islamic normative theory of lawful profits (Rosly, 2001; Abdullah, 2016). Kahf and

Khan (1992) identify the Prophetic saying of *al-kharaj bi al-dhaman*¹, the Islamic legal maxim of *al-ghunm bi al-ghurm*² and *istimrariyyah al-milk*³ to be central axioms of IF; in transactions involving the direct ownership of physical assets such as sale and lease, the latter maxim applies in which case Kahf and Khan (1992) assert, “the first and foremost axiom for the justification of return is the ownership of an asset.” (p.39) The Prophetic saying *al-kharaj bi al-dhaman* and the *al-ghunm bi al-ghurm* maxim apparently applies to transaction across the board as will become clear in Chapter 2.

The point is that literature and theory has generally idealized these concepts while practice has not as is evident from the writings from the likes of Kahf and Khan (1992), Iqbal (1997), Usmani (2002) and Farooq (2007). Some have taken to reinterpreting these idealized principles of the normative theory of lawful gain such as Hamoud (1982), Tantawi (Al-Salus, 1995) and Farooq (2007), while others have simply identified the impracticality of enforcing such ideals (Dar & Presley, 2001). Others such as Kuran (1995) which have a largely orientalist approach criticize such ideals without clarifying the purpose or viable alternative that fall in line with Islamic principles of commercial law (*fiqh al-mu'amalat*). While it is the goal of this research to elaborate such opinions in the results and findings after conducting the research, it is relevant to summarize the debate here so that the reader has an overall picture before the previous literature is discussed. The literature review and findings will discuss the parameters of reward-risk in-depth, but they are presented here for demonstration:

¹ Which is translated to mean that reward (return) is matched with (made lawful with) guarantee (bearing loss). This Prophetic tradition has been transmitted by a number of *hadith* scholars including Abu Dawud (n.d.) and others such as Ibn Majah and Al-Tirmidhi and has been graded as *hasan*, or good in its authenticity (Abu Dawud, n.d.).

² Which is translated to mean that earnings are (due) with loss (bearing loss)

³ Which refers to (the risk of) continued ownership (Uwaidha, 2010)

Ownership risk	The risk of owning an asset such as the risk of not being able to resell an asset owned by the bank
Market risk	Refers to the risk of reselling an asset or the variability of its value or the value of its returns which due to the change in market rates such as the loss experiences in the sale of an asset held by the bank.
Capital loss risk	The loss experienced due to reselling assets at a loss such as the loss experienced in unwinding a musharakah venture.
Liability (<i>dhaman</i>)	The responsibility of bearing a loss or risk that comes with a contractual undertaking or otherwise such the bank's liability in the destruction of its leased asset.
Costs	The costs related to owning an asset or maintaining an asset's proper functioning
Value-adding	The value added to the economy from an economic transaction such as a financing activity of an Islamic bank

Furthermore, as will be evident from the findings of this study, the main products types that are built on the contracts selected for this study are as follows:

MPO	Trade finance, vehicle finance (term finance)
AITAB	Vehicle finance (retail/business); other completed asset acquisition (term finance)
MMP	Home finance (term finance)

1.2 RESEARCH PROBLEM

There are several dichotomous lines that tend to form when it comes to establishing the Shari'ah basis for transactional dealings in Islamic Finance (IF). Such dichotomies exist partially as a result of unwarranted veneration of certain injunctions or principles of the Shari'ah. This theoretical approach influences industry practice that has indeed varied (Hasan, 2005; Farooq, 2007), in different hubs of IF, as well as the standards set by the bodies that IFIs in the different hubs follow.

The reward and risk (simply reward-risk) principle in IF specifically, has long been recognized as the ideal basis distributing the product of any market-related arrangement in IF and is perhaps subject to the veneration previously alluded to. Such a speculation is the subject of examination of this study. Reward-risk refers to the equitable division of rewards and risk among factors involved in the production (Chapra, 1992). However, such a view has been and still is subject to contention and controversy as to the extent of its scope. The focus of IF experts when discussing reward-risk is the domain of wealth distribution and the Shari'ah injunctions that pertain to it. Distribution refers to the division of products among participating factors (Abojeib, Haneef, and Mohammed, 2018). The primary goal in distribution in Islamic economics and finance is distributional equitability. Hence, the primary concern in Islamic economics and finance is not production, but in regulating distribution instead, with the Shari'ah giving much attention to it rather than production (Abojeib *et al.*, 2018). This is another speculation of Islamic economists that requires further scrutiny.

Advocates of reward-risk application in what can be described as a literal sense generally view the reward-risk principle as strictly applicable to Islamic financial exchange transactions across the board, regardless context. So, sale-based financing must subject the financier to the change in price (market risk) of the asset

being financed (sold), while in lease-based financing, the ownership and rental prices must also be subjected to price risk, and in partnership contracts, returns on principle and redemption of shares must adhere to the prevailing market rates and to the concept of profit-sharing or profit-and-loss sharing. Market risk is non-negotiable element to which every exchange transaction must be subjected to. This is characteristic of the participatory approach to financing in which to earn reward on the financing, the financier must bear – ‘participate in’ – the relevant risks of loss (Hussain, Shahmoradi, and Turk, 2016). Hasan (2005) attributes the aforementioned approach to the Jeddah school of scholars like those at King Abdulaziz University and IRTI. Although participatory relates to equity-based arrangements as noted by Khan (2010), the participatory approach influences non-participatory arrangements like sale and lease modes by requiring the financier to partake in the risks of market prices and ownership that directly affect the financier’s rewards and risks. The latter are identified as the non-participatory ‘weaker’ or ‘secondary’ modes of Islamic finance (Khan, 2010).

This understanding has been judged by others as rather a slight misunderstanding; this other collection of literature differentiates between participatory merchant financing and pure financial intermediation (FI), a concept alien to traditional juridical literature (Kahf, 2006). In such literature, market and ownership risks may be minimized to the farthest possible extent meaning that the financier may not necessarily partake, at least not in spirit, in the risks involved in the asset or venture being financed. So, sale prices may be guaranteed through the binding *wa’d* (undertaking) mechanism⁴, while lease-financed asset values may be completely

⁴ An undertaking (*wa’d*) in *mu’amalat* may or may not be binding. The jurists have differed on the issue. Those who view it is binding include a variety of jurists from different schools such as Al-Shaybani, Al-Ghazali, Ibn Al-‘Arabi, some Hanbalites, and some Dhahiriyyah. The main position held by

recovered by the financier, while alternative mechanisms of partnership-based financing have been developed so as to allow the financier to recuperate its capital like the *musharakah mutanaqisah* partnership (MMP). There is further justification for such methods and claims that they still embody the principles of equitability in bearing risk in return for the reward to the financier. Kamali (2002) concludes that there is a lack of consensus on the viability and adequacy of a single principle of distribution, as in the case of reward-risk. A number of claims are attributed to a number of practitioners and industry-participating scholars in Malaysia (Hasan, 2005). However, from a number of resolutions of standard-setting bodies and Shari'ah committees of Islamic banks that will follow, one will notice that such attributes are characteristic of Middle Eastern Islamic banking (IB) practices as well. This approach is less participatory in nature, although it may itself utilize participatory means such as the MMP.

Yet another aspect of the literature adopts unorthodox approaches to such issues including the permissibility of foregoing the currently established normative parameters of reward and risk for an alternative utility which is dictated by the circumstances of the day and age. Some examples include the guaranteeing of capital and profits for investment account holders (IAHs) to retain them since the alternative for them would be to deposit such funds with conventional financial intermediaries to insure their capital is protected. Some of these propositions have been met with serious criticism across the board (Tantawi, 2003; Khafif, 1997; Hamoud, 1982).

The implication of *al-kharaj bi al-dhaman* and *al-ghunm bi al-ghurm*, which comprise the reward-risk theory, and their dimensions in Islamic law lack a dedicated

the generality of the juristic schools is that fulfilling an undertaking it is merely commendable. Finally, others view that fulfilling an undertaking is an ethical obligation (*wajib diyahah/diniyah*) and not a legal one (*wajib qadha'/qadha'i*) (Al-Dughaythar, n.d.).

study. Furthermore, essential modes of asset finance in the Islamic banking practice, *murabahah* to the purchase orderer (MPO), *al-ijarah thumma al-bay'* (AITAB) and MMP are examples of financing methods vulnerable to criticism as to their compliance to the reward-risk requirements which may have serious implications as to proper understanding of the reward-risk principle. The complicated nature of these hybrid contracts complicate their reward-risk features and have thus been a subject of much criticism as will become clear from the following literature in Chapter 2. A new dynamic set of parameters that consider the evolving nature of transactions needs to be proposed and specifically for the MPO, AITAB and MMP in the Malaysian IB context which may be generalized to other products and contexts.

1.4 RESEARCH OBJECTIVES

This study then has the following set of objectives:

- 1) To examine is the concept and application of reward and risk in Islamic finance.
- 2) To investigate the application of reward and risk in MPO, AITAB and MMP products in the Malaysia IB context.
- 3) To proposed a new set of dynamic parameters for the selected IB products.

1.3 RESEARCH QUESTIONS

Based on the problem statement, the questions posed by the study are

- 1) What is the concept of reward and risk Islamic finance?
- 2) How is reward and risk applied in the MPO, AITAB and MMP products in the Malaysian IB context?

- 3) What are the proposed new set of dynamic parameters for the selected IB products?

1.5 SCOPE OF THE RESEARCH

The scope of this research will be limited to the Malaysian IB context. Furthermore, the analysis of the practice will be limited to industry/library documentation and some input of the interviewees. Finally, the issue treated is the reward and risk element of IB products. The obvious choice for the choice of the selected IB products of MPO, AITAB and MMP is due to their widespread criticism and their importance as a financing tool. The practice will refer to industry literature such as policy documents and product disclosure sheets, as well as library literature discussing the practice – only. However, library literature is the other limit of the research when initially discussing the concept of reward and risk in Islamic finance since the library resources provide sufficient information for that purpose. Finally, the element of reward and risk that is the only scope that will be studied is, as in the problem statement, generally a subject of insufficient concern, focus and emphasis.

1.6 SIGNIFICANCE OF THE RESEARCH

For academics, the research is expected to advance a dynamic theoretical approach to reward and risk in IB and finance setting the tone for future research in further grounding a standard theory of reward and risk sharing. For the industry, it is expected to add new perspectives for flexible template for reward and risk in IB products through consideration for multiple dimensions of reward and risk sharing, especially hallmark financing products such as MMP, MPO, and AITAB. For policymakers, the same perspectives contributed by the research can be used in legal/regulatory policy.

1.7 CHAPTERIZATION

This study will follow a conventional approach starting off with an introduction on the background of reward-risk, the research problem, questions, objectives, scope and significance.

The Second chapter will study the literature discussing the parameters of reward-risk in general, then the literature which criticizes Islamic banking practices on in the context of reward-risk, and finally literature discussing the application of reward-risk to the selected Malaysian IB financing products. The literature on contemporary Islamic legal theories will be discussed which will be the reference for deriving the new parameters of reward-risk in answering the third question of this study.

Chapter three will detail the design of the research, the conceptual framework, the research methods which are largely qualitative, and finally data analysis including the sources and form of analysis.

Chapter four will be the core of this study analyzing the findings which include, first, an identification and analysis of the current normative parameters of reward-risk as advanced by academicians and scholars. Second, the Malaysian banking practice concerning the reward-risk elements of the selected financing products of the MPO, AITAB and MMP are analyzed from products disclosure sheets, policy documents and literature. Finally, a new set of parameters is proposed based on the Malaysian IB practice concerning the selected financing products which discussed a higher set of parameters and reinterpreting the former set of parameters of reward-risk.

Chapter five will summarize the findings and propose recommendations for academic research and policy action.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

The review of the literature will first give a background of the concept of reward and risk in Islamic finance including classical commercial law. The criticisms directed at the reward and risk practice in Islamic banking will also be discussed. The reason for this is that the reward and risk principle permeates a great number of aspects of Islamic banking and so allow for a comprehensive analysis of the dynamic methods of application of reward and risk.

Then the criticisms of its application will be discussed along with its appropriate application in the selected contracts of the research. Finally, the literature on contemporary juridical theories and principles will be explored for purposes of discussing the proposed new parameters.

2.2 BACKGROUND AND CONCEPT OF REWARD AND RISK

Classical Islamic jurists (*fuqaha*) have since long ago emphasized the importance of the embodiment of reward-risk in transactional dealings from criminal matters (Al-Sarkhasi, 1993; Abulfadhl, 1937), to non-market domain of IF such as of *waqf* (Abulfadhl, 1937), to a variety of different issues in market-related transactional dealings like sale and lease contracts, guarantees and collateral, etc. (Al-Zuhaili, 1984; Uwaidha, 2010); even in the restricted domain of inheritance, the reward-risk equation is applicable (Ibn Abideen, 1992). Most surprisingly, the classical jurists have even found applications for the principle in practices that are partially devotional like *zakat*