

# The Comparison Between Transactions Based on Debt Vs. Transactions Based on Equity: Literature Review

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## ABSTRACT

Islamic finance offers an alternative to society through the Islamic banking system, takaful (Islamic insurance), and capital market goods and services. The explosive growth of Islamic banking products has experienced double-digit annual growth since its inception. Islamic Financial Institutions (IFIs) are being pushed to create new products to meet the ever-changing needs of their existing and potential customers as a result of the rising popularity of Islamic banking. However, Islamic banking products still face challenges in Islamic banking institutions across the world. Therefore, the purpose of this study is to examine the Polemic of Debt-based vis-s-vis Equity-based transactions. The methodology that has been utilized in this study is the literature review. This paper aims to highlight Islamic finance methods, particularly debt and equity-based financing discussed the present challenges surrounding debt and equity-based financing. The finding suggests the main factors which hinder the application of musharakah and mudarabah by Islamic finance products, namely high risk, asymmetric information, capital guarantee, lack of awareness, and lack of knowledge of the equity-based products and issues related to debt-based transactions. Finally, this study recommends that Islamic financial institutions, banks, and regulators should fully implement equity-based contracts.

**Keywords:** Debt financing contracts, Equity financing contracts, Issues, and challenges

## 1. INTRODUCON

Islamic banking and finance have grown to the point that they are now the primary funding source in several Muslim-majority nations. The conventional system, which was adopted by Islam a few years ago, has gained widespread acceptance, mainly of Islamic debt-based commodities, which have made it relatively simple for people to get cash. Islamic debt-based contracts may be seen as beneficial to economic growth, especially in emerging countries such as Malaysia and the Middle East, where Islamic financing, particularly in infrastructure, is helpful to economic development. Consequently, some observers say that debt-based financing is the bedrock of the Islamic financial system, stating that "these (Islamic debt-based financing techniques) are judged adequate for the rural people's diversified credit requirements." (Firdaus & Hatta, 2014).

Islamic financial institutions were set up in the modern era. The first one was an Islamic bank in the Middle East, which opened in the 1960s. In 1999, Rahul and Sapcanin did the first in-depth study of how Islamic finance and microfinance work together. An MFI can use *mudarabah* (profit sharing), *musharakh* (joint venture), and *murabaha* (cost plus markup), which are three of the most important Islamic finance contracts, to create effective microfinance programs. *Mudarabah* and *musharakah* are both funded by equity, while *murabaha* is funded by a loan. In Islamic finance, profit and loss sharing (PLS)-based equity financing is distinct from conventional finance.

Several studies have shown that equity financing is good for the Islamic finance industry. But there hasn't been a lot of real-world research on how Islamic equity financing affects the well-being of rural families. Fianto et al. (2018) say that they looked at two years' worth of panel data to learn more about how equity finance affects the well-being of rural households. They found that equity-based financing had a bigger effect on the income changes of rural residents than debt-based financing could do.

The financial system is a subset of economics critical in constructing society's well-being via various concepts and methods for effectively enhancing economic development, ultimately impacting people's livelihoods. Nevertheless, financial institutions, governmental and private institutions have used debt and equity products to assist big, small, and medium-sized businesses in following out their financial goals and ambitions. Interestingly, the earlier appears to be the financial institutions' preference over the latter in Islamic and conventional economic systems, owing to specific problems, namely self-interest and inclination, which are more prevalent in the conventional method. Additionally, debt-based financing was identified as the root cause of the 2008 financial crisis. Individuals are carrying massive borrowings on their necks due to debt financing provided based on credit with accumulated interest owing to an inability to repay the loans obtained.

In a financial crisis, Islamic finance Was seen as a viable alternative to the conventional financial system. Inadvertently, Islamic banking seems to be quite similar to traditional banking in reality, which is mainly reliant on debt financing (Maikabara et al., 2020). Products offered by Islamic banks are in high demand because of the expanding demands of the Islamic community. They are seen as a practical replacement for conventional banking, which is reviled for its *gharar* (uncertainty), *riba* (usury), and *maisir* (double- or triple-charging) (gambling). Muslims are now able to take part in the non-shariah -compliant banking sector due to the increasing number of Islamic banking products. The Islamic banking industry has adopted a wide variety of Islamic financial solutions. Since they can eliminate *gharar*, *riba*, and *maisir*, they hold great growth potential. There are many different types of financial products available through Islamic banks now, such as *ijarah*, *Murabaha*, *bai' bithaman ajil*, *istisna*, and *tawaruq*. "(Abdul-rahman, 2017).

Conventional banks' primary line of business is debt-based financing, which is predicated on the dishonestly augmented value of borrowers' assets as a result of compounding interest. Islamic banking, on the other hand, appears to function similarly to conventional banking, with a focus on debt financing that abides by Shariah rules via underlying Islamic contracts. Islamic finance frequently employs debt-based financing, including mortgages and car loans. Product sales are used to generate this type of capital. Some examples include *musharakah muthanaqisoh* (dwindling *musharakah*) with an underlying asset, *Ijarah* (lease), *bai' bithaman ajil* (delayed payment contract), *bai' al-muajjal* (credit sale), *bai' istisna* (manufacturing contract), *bai' murabaha* (advance sale), and *bai' al-salam* (advance sale). While the term "equity-based finance" refers to a specific type of funding that is often used in partnerships where both parties share in the profits and losses, "debt-based finance" refers to financing that is not shared between the two parties. The two main contracts in this area are the *musharakah* (profit sharing) and the *mudarabah*.

*Musharakah* is capital invested in actual economic activities by two or more parties who enter into a contract and contribute to the capital or management of a partnership with similar rights and liabilities, assuming the risk and having an achievable amount of profit and loss to be shared by them according to the proportional ratio prescribed by *musharakah* and profit-sharing defined by *mudarabah*. Studies show that debt financing makes up the vast majority of financing in Islamic banks, with equity financing making up the remainder. (Why Shariah -compliant Equity-based financing is less of a priority for Islamic Banks than Debt-based financing). This is because equity-based financing contracts are more susceptible to problems like the moral hazard issue caused by ex-post information asymmetry (*musharakah* and *mudarabah*) (Maikabara, 2019).

## 2. LITERATURE REVIEW

### Definition, Nature & Concept

Islamic banks primarily provide two types of project financing: Islamic debt-based financing and equity-based financing. Each kind of financing is founded on a different set of pre-contractual provisions inherited from Islamic business law. *Musharakah* contracts are profit-sharing arrangements in which two or more partners contribute monies to form a joint investment. Profits are shared between partners following an agreed-upon ratio, while losses are shared following the contribution ratio (Jais et al., 2019).

In conventional financial systems, debt-based and equity-based financing is based on interest (Maikabara et al., 2020). In particular, in the debt financing product, the lender should charge extra money to the borrower for the use

of money. Meanwhile, in equity-based financing, more than one person comes together to invest in a project, and each of them pays a sum of equity. Hence, the shares depend on contribution. These contracts can create financial crises and instability, as happened in 2008. The main reason is that interest usually makes financial concerns. For example, if a person takes a loan from a conventional bank, the loan taker will be charged a percentage of interest for the use of the money. If the borrower does not pay the loan plus interest, the bank can face losses and bankruptcy. This is the starting point where the financial crisis started.

On the other hand, in the Islamic financial system, debt-based financing and equity-based products are free from interest (*Riba*). These two financing contracts are based on shariah rules or Maqasid al-shariah. Debt-based financing is a mode of financing for specific contracts where both sides are fully ready to sign the contract. This mode of financing is a sale transaction. Car financing, house financing, makeup sale, advance sale, manufacturing sales, and many other financing types are under debt-based financing products. While equity-based financing is an investment that deals with tangible assets, many parties agree to the project by specifying proportions or management of the partnership, risk-sharing, and identifying that profit and loss will be shared according to the balance of capital invested (Maikabara et al., 2020).

### **Debt-Based Financing Product**

Debt is a legal duty or obligation to pay for or provide something. Islamic debt-based finance is a kind of financial facility that satisfies people's demands, wants, preferences, and desires for luxury without resorting to a slew of prohibited instruments. Islamic banks provide various products and services, all comparable to conventional (Firdaus & Hatta, 2014). According to (Hassan, 2011) Debt-based finance is the primary business of conventional banks and is based on the inaccurate enhancement of property via compounding loan interest. On the opposite, Islamic banking seems to be similar to conventional banking in practice, relying heavily on debt financing while adhering to Shariah rules via fundamental Islamic contracts. Debt-based financing is a kind of financing that is commonly used in Islamic finance, such as house financing, car financing, and others. This method of funding is facilitated through selling transactions. These include *bai' murabaha* (advance sale), *bai' al-salam* (advance sale), *bai' istisna* (manufacturing contract), *bai' al-muajal* (credit sale), *bai' bithaman ajil* (delayed payment contract), *ijarah* (lease contract), and *musharakah muthanaqisoh* (dwindling *musharakah*) with an underlying asset (Maikabara, 2019).

Islamic banking's operations include the channelling of cash through *murabaha* finance products. *Murabaha* sells items at their original price with an agreed-upon benefit. The *murabaha* feature is that the vendor must tell the customer of the product's buying price and the profit margin added to the cost. In Islam, there is also a prioritization of *kaffah* (whole) in religious practice. Based on these considerations, Islamic banking activities also necessitate integration with shariah -compliant services in general. Thus, beginning with the product of manufacturing activities or the time of the transaction, it is necessary to guarantee compliance with shariah rules throughout the procedure in order to prevent the issue of non-compliance (Prabowo & Jamal, 2017).

*Murabahah*, *bai' salam*, *ijarah was Iqtina'*, and *Qard al Hasanah* are all terms used to describe debt-based financing with non-PLS contracts. *Murabahah* is a kind of short-term finance contract. The seller reveals to the customer the actual cost and profit of the goods under this contract. Profit margins may be negotiated, and instalment payments are frequent. A *bai' salam* is a kind of advance contract. The vendor and the buyer agree to a future transaction in which the buyer pays the entire price and the seller guarantees delivery of the items.

Meanwhile, equity financing is primarily based on *Mudarabah* (profit sharing) and *Musharakah* (joint venture) with a profit and loss sharing agreement. A *Mudarabah* contract is a profit-sharing arrangement. The Islamic financial institution provides all the money required for the company or project in exchange for the customers' work and time. Profits are distributed in a predetermined ratio, but Islamic financial institutions absorb losses. A *Musharakah* contract is a PLS contract in which different parties invest equity in a project, and earnings are divided in an agreed-upon manner (Fianto et al., 2018). The main types of debt-based financing contracts are as follows: *mudarabah*, *qard al hasanah*, *ijarah*, *istisna* and *salam*.

### **Equity-Based Financing Products**

a) *Mudarabah*

*Mudarabah* agreement can take the form of either a savings or investment account, or even a loan for a specific project. When it comes to the former, the client plays the role of *rabbul-mal*, while the bank acts as the manager of the investment portfolio. Before entering into this agreement, the client and the bank settled on a profit split. Furthermore, the fund's assets must be invested in shariah-compliant ventures. The client bears all responsibility for losses, not the bank. When a bank provides funding for an endeavour, the bank assumes the role of capital provider, and the terms of the *Mudarabah* must be met. However, *Mudarabah* is a brand that is largely unknown outside of Malaysia. There are many dangers that it could cause for Islamic financial institutions. *Mudarabah* contracts ensure both interest and principal payments. The bank takes on additional danger because it acts as a source of funding. (Jais et al., 2019).

To achieve the socio-economic welfare of society or the economic outcomes contracts proposed by Muslim academics and non-Muslim scholars, equity finance is the path to reach the level of worldview indicated in *Maqasid al-shariah*. Consequently, equity financing has long been a goal of shariah counselors and academics that must be realized in Islamic banking and finance, as equity financing is based on profit-loss sharing based on the financial commitment to the project or investment. Furthermore, equity financing is not a substitute for the debt-based financing arrangements prevalent in conventional banking. Thus, equity finance may ultimately contribute to shariah's goal of social justice. (Yusof & Fahmy, 2009).

b) *Musharakah*

In Arabic, *musharakah* means "sharing" or "combining." The Arabic words for partnership that are similar to *musharakah* are *shirkah* and *shirk*. So, *musharakah* is an act or agreement between two or more people that makes them work together. It is a type of financing in which everyone has a direct stake and benefits from both profits and losses, as needed. An alternative term for Allah's collaborators is *shirk*. *Musharakah* is a word for a business partnership in which all members (two or more) share both profits and losses in a way that has already been decided. It is a way for banks to finance projects based on the idea that everyone should get a share of the profits. Each contracting party can contribute money, time, skills, or a combination of these things, as agreed upon by all parties in the *Musharakah* investment agreement. All contracting parties get the same number of profits and losses. Profits, if there are any, are split between partners in the way that was agreed upon. At the same time, losses, if any, are directly tied to the amount each person invested in the company. (Farooq & Mushtaq Ahmed, 2013).

**Legal Requirement**

The resilience of the Islamic financial sector must be increased through ongoing regulatory and legislative changes in order to ensure the system's continued growth and development. There is now broad agreement among academic studies that Islamic financial institutions, in particular, require a strong legal and regulatory infrastructure. Most people agree that the best way to ensure the continued success of the financial services sector is to establish a robust legal and regulatory framework that sufficiently protects all parties involved. While some countries have begun to make accommodations for Islamic financial infrastructure, the vast majority of countries that have chartered Islamic banks still hold Islamic banking firms to secular legal and regulatory frameworks. Only Malaysia is taking such drastic measures. Known as the Islamic Financial Services Act of 2013, the government's new set of Islamic banking regulations (Sekoni & Abiola, 2015).

On June 30, 2014, the Islamic Financial Services Act (IFSA) was implemented in Malaysia. Financial stability and shariah compliance, along with matters related, consequential, or ancillary, are promoted through the IFSA's regulation and supervision of Islamic financial institutions, payment systems, other relevant entities, and the Islamic money market and Islamic foreign exchange market. To further the goals of the act, Bank Negara Malaysia, the country's central bank, is currently drafting a number of standards for major Islamic contracts that define the shariah and operational criteria of a given contract. This step does a number of things, including prohibiting principle and profit guarantees in investment accounts and separating investment accounts from Islamic deposits. By giving shariah contracts in Islamic financial transactions more weight, the IFSA expands the scope of the regulatory system



for Islamic finance. To ensure the successful implementation of shariah contracts in the provision of Islamic financial products and services, the IFSA has established a statutory basis for a contract-based regulatory framework.

This is a significant step toward aligning legal and regulatory principles with shariah principles and may serve as a valuable benchmark for developing more inclusive regulatory frameworks that encourage more legal and regulatory certainty in Islamic finance on a global scale. More crucially, it builds the contract-based regulatory framework to enable Islamic banking to go to the next level, transcending financial intermediation to encompass genuine economic sector engagement. Such a novel regulatory strategy aims to enhance the value proposition of Islamic finance as the sector matures and becomes more sophisticated (Komijani & Taghizadeh-Hesary, 2019). At Islamic banks, laws and legal requirements are essential. Because it reduces misunderstandings and disagreements among Islamic banks and their customers, legal is the best to clarify everything about the services or products banks offer. The central banks approve the products and services that banks provide to the countries. However, there are unique legal requirements that Islamic banks set to ensure their property. The debt-based financing contracts is the one that customers use the most. It is not easy for the bank gives a loan to someone.

Nonetheless, several conditions must be followed to provide loans. The main reason for these conditions is to create trust between banks and customers. Furthermore, equity-based financing products have essential requirements that must be fulfilled. Bankers and financial practitioners may utilize a variety of contracts. Still, the most prevalent debt contracts used in banking and finance today are based on the notion of so-called Islamic devices. The judgment on that contract law is mainly based on the classical legal ideas of certain schools of Islamic law (Firdaus & Hatta, 2014).

In Malaysia, The Islamic Banking Act 1983 was officially designated and came into force on 7 April 1983 to pave the way for the formation of Islamic banks. This act establishes the standards that Islamic banks must follow to operate in Malaysia and the Central Bank of Malaysia's authority to supervise and regulate Islamic banks in Malaysia. Simultaneously, the Government Investment Act 1983 was approved, authorizing the government to issue Government Investment Certificates based on shariah principles. The Islamic Banking Act (IBA), which took effect on 7 April 1983, provided the legal framework for creating Islamic banks. The IBA empowers Malaysia's banking regulator, BNM (Bank Negara Malaysia), to monitor and regulate Islamic banks in a manner comparable to that of other regulated banks. Simultaneously, the Government Investment Act 1983 was adopted, authorizing the Malaysian government to issue Government Investment Issues (GII), which are government securities issued following shariah standards (Sufian et al., 2012).

Islamic banking is a financial sector based on Islamic principles. It is an economic system based on shariah law, i.e., Islamic jurisprudence derived from the Quran and Sunnah of the Prophet Muhammad (PBUH). Its activities must adhere to shariah standards and refrain from violating any shariah concept (Muhammad, 2014). In debt-based financing contracts, specific legal requirements must be fulfilled before the loan occurs. The bank and the customer must agree on the type of debt-financing products. Is it *murabaha* or *ijarah* or others? In addition, the bank will check the customer's loan history to see if there is a payment pattern. Was the customer paying loans on time, or was he/she not good at loan repayment? Also, the bank must specify the amount of mark-up and the initial price of the goods. Furthermore, the bank and the customer should determine when the loan must be repaid. All these requirements reduce the probability of misunderstandings and loan default as well. All these loan transactions are supervised by the central bank and are based on the country's financial laws.

Islamic banks' fast worldwide expansion and expansion outside local jurisdictions need to create their financial infrastructure to ensure the Islamic financial industry's performance and stability. These organizations are vital to the Islamic financial industry's framework up to international standards. Three primary reasons support the need of these institutions: 1) advancement of shariah law rules and standards in the form of financial reporting standards, regulatory rules for multiple types of institutions, business rating methods, transparency measures, and a code of ethical behaviour; 2) implementing rules and regulations for the guidelines and norms in the form of active monitoring and supervision; and 3) collaboration of the rules and principles across nations, market participants, and requirements (Zulkhibri & Majid, 2012).

### **Shariah Requirement**

Islamic banks offer Islamic products and services equivalent to their conventional counterparts in functions, operations, instruments, and advantages, such as Islamic credit cards. It is a privilege and a benefit of this kind of financing because correct cooperation between creditor and debtor may be established, based on the Islamic legal system and restricted to acceptable subject issues as regulated by shariah (Firdaus & Hatta, 2014). Islamic banking is a financial sector based on Islamic principles. It is an economic system based on shariah law, i.e., Islamic jurisprudence derived from the Quran and Sunnah of the Prophet Muhammad (PBUH). Its activities must adhere to shariah standards and refrain from violating any shariah standard (Muhammad, 2014).

By generating shariah compliant contracts, Islamic scholars developed alternatives to traditional banking. Numerous Islamic banks have been created throughout the Middle East and portions of Asia as a result of the increasing demand for shariah-compliant financial services, including Malaysia (1963), Bangladesh (1983), and Indonesia (1983). (1991). The Islamic Development Bank (IDB) was founded in 1975 as a regional growth agency to encourage Muslim nations' economic development and provide Shariah -compliant credit. The Islamic Financial Services Board (IFSB) is an international organization that develops and publishes Shariah -compliant standards to promote the security and well-being of the Islamic financial services sector, particularly banking, insurance, and capital markets principles. The IFSB's operations supplement the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors' measures and activities. The IFSB, headquartered in Kuala Lumpur, was inaugurated in November 2002 and began operations in March 2003 (Komijani & Taghizadeh-Hesary, 2019).

Consequently, the primary shariah requirements are that all debt and equity financing methods be interest free, that uncertainties be avoided, and that all gambling and alcohol-related businesses be outlawed entirely. Furthermore, contracts must be transparent and complete in terms of mutual agreement between the parties involved. The responsibility of the house should be obtained directly from the developer in a true *murabahah* sale under a BBA (*Bai' Bithaman Ajil*) contract. However, the ownership of the house should be obtained from the developer in a partnership MM (*musharakah mutanaqisah*) financing product. Both stakeholders should purchase the request of the house from the developer at the same time. Due to tradition, national regulations, and ownership-related duties, Islamic banks cannot participate in S&P agreement negotiations. Aside from that, under contracts like the *Murabaha*, the *musharakah*, and the *ijarah*, the property owner is accountable for all risks and responsibilities associated with the specific dwelling. On the other hand, the banks are not ready to assume ownership-related risks or liabilities since, in their opinion, it is not appropriate in the banking sector. Thus, if banks continue to support the BBA or MM products in this situation, compliance of shariah standards is in doubt (Azaheem & Aswer, 2019).

Shariah regulations about *mudarabah* and *musharakah* When it comes to Islamic financial instruments, both IFIs, and their clients must follow Shariah principles. Notably, Malaysia lacks a documented shariah rule for implementing *mudarabah* and *musharakah* -based microfinance. As a result, this research has opted to adhere to the general shariah norms given by Bank Negara Malaysia (BNM, 2007, 2010, 2012, 2015) for Islamic banking and financial activities. In this situation, the fundamental shariah laws were adopted for their suitability and flexibility to the architecture of M&M finance (Islam & Ahmad, 2020).

Islamic banking activities are substantially governed by shariah (Islamic law), which establishes the type and character of the deposits and financing system. The primary distinction between an Islamic bank and a normal bank is the contractual parties' conduct. In Islam's financial system, God establishes the laws via the Holy Qur'an and Prophetic Traditions. As a result, revenues in Islamic banking are earned from trade contracts (*al-bai'*) rather than interest-bearing loans. Profitability in Islam is determined by commercial risk-taking, not financial risk-taking. A contract of trade involves the exchange of money for an underlying asset. Still, an interest-bearing loan involves exchanging some money for more money, which is banned by *riba* (interest). *Riba* is a phrase that denotes the lending party's predefined and contractual rise over the principle. *Riba* was an exceedingly demanding commercial activity in pre-Islamic Arabia, where a loan (*Qard*) would double and redouble if the borrower failed to repay.

Islam prohibits profiteering from commerce (*al-bai'*). As a result, *riba* was labeled an unethical commercial transaction. The merchant takes a risk with his cash and provides value to the firm via sales and advertising operations while offering guarantees on the items sold. These characteristics of risk-taking (*ghorm*), labour and effort

(*kasb*), and accountability (*daman*) justify trade gains. The most basic of them is the risk-taking principle, which states that money must be permitted to depreciate as a result of market movements. Money cannot appreciate on its own, the- rationally. This indicates that money must be turned into capital in order to demand earnings since capital's value depreciates or appreciates as it is funnelled into trade and commerce (Ariff & Rosly, 2011).

*Murabaha* funding methods must adhere to the rules of the Indonesia National Sharia Board's Fatwa No. 4/2000 on *murabaha*, which was confirmed on 1 April 2000. Among the requirements are that shariah rules do not forbid the traded goods; that the bank purchases the goods required by customers on behalf of the bank and that the investment is valid and without usury; that the bank submits all matters relating to the purchase —for example, if the purchase is made on loans — and that the bank sells the product to the customers (purchasers) at the selling price and benefit. In this sense, the bank must be forthright with its clients on the pricing of commodities (Maksum, 2018).

The most widely utilized Islamic financing technique by Islamic banks and financial institutions worldwide, *murabaha* is a critical concept in Islamic finance. However, the over-dependence on *murabaha* has raised concerns regarding its shariah compliance and methodology. Most Islamic banks use *murabaha* as their primary financing option/product, even though it is one of the least suitable Islamic financing modalities, according to most Islamic finance specialists worldwide. In certain places and countries where Islamic banking is booming, for example, Malaysia and other Middle Eastern and Gulf States, Islamic financial instruments like *tawarruq* and *murabaha* are the most often utilized, indicating a lack of conformity with shariah 's strict rules. This is an unpleasant reality that if we do a thorough analysis of the products and services offered by Islamic banking and financial companies, we will quickly discover that *murabaha* is the most often used method of Islamic financing (Ali et al., 2017).

On the other hand, A *mudarabah* contract is a kind of contract that may be used to fund an investment account or a project. In the latter, the consumer serves as the *rabbul-mal*, and the bank acts as the fund manager. In this instance, the client and bank agreed on the profit-sharing ratio at the contract's inception. Additionally, the fund's assets should be invested in basing on shariah requirements. The bank will not be liable; the client is responsible for any damages. In project finance, the bank will act as the capital provider, and all *mudarabah* requirements must be followed (Jais et al., 2019).

## OPERATIONAL REQUIREMENT

The PLS sharing plan has also been supported by national regulatory organisations like the Bank Negara Malaysia (BNM) in Malaysia and the Otoritas Jasa Keuangan (OJK) or Indonesia Financial Services Authority (IFSA) in Indonesia. Shariah standards and Operational Requirements on *mudarabah* and *musharakah* were released by BNM in 2015. The rules aim to improve transparency and consistency in the application of shariah contracts, bolster shariah compliance by Islamic banks in Malaysia, and increase the certainty of contracts. The OJK also issued a circular letter in 2015 outlining the regulations for Islamic banking products and services. Specifically, the rule was made to help the Islamic banking sector in Indonesia create and supply shariah-compliant products and services, such as funding and financing (Yustiardhi et al., 2020).

Additionally, it controls the use of *mudarabah* and *musharakah* contracts for funding and financing items. According to these two national regulatory methods, there are various parallels and variances in the *musharakah* and *mudarabah* criteria that may encourage Islamic banks to provide these financing products, as shown in Table 1. At the same time, the OJK legislation establishes broad guidelines for using Islamic contracts to provide banking goods and services. The BNM guidelines are divided into two sections: Shariah and operational criteria. Shariah 's requirements concentrate on a particular contract's salient features and essential conditions.

The latter, in contrast, establishes guidelines for moral and lawful business practices and market behaviour, including good governance and oversight, appropriate product structuring, efficient risk management, open financial reporting, and more (BNM, 2015). Different parts of each contract, such as risk management and good governance, are dealt with by different OJK statutes than the BNM principles. The results were published in 2020 (Yustiardhi et al., 2020). Based on his findings, microfinance institutions would benefit from using the limited *mudarabah* (*mudarabah muqayyadah*) contract rather than the unrestricted *mudarabah* (*mudarabah mutlaqah*). With absolute *mudarabah* in place, the *rabb al-mal* is not allowed to intervene in the company's affairs. To the contrary,

restricted *mudarabah* permits restrictions to be placed on a company's operations. Unrestricted *mudarabah* is also harder for the funding institution to keep tabs on.

**Table 1: Comparative BNM and OJK Guidelines on *murabaha* and *musharakah***

(1) Issues	BNM syariah and the operational requirements of <i>musharakah</i> and <i>murabaha</i>	OJK circular letter Codification of Islamic banking products and activities
(2) Regulation coverage	The Shariah Standards consist of two components – the syariah standards and the Operational Requirements.	Only regulates the operational requirement. The Shariah principles are based on the <i>fatwa</i> issued by the National Sharia Council (DSN) - Indonesian Ulema Council (MUI) No restriction.
(3) Sources of funds	For <i>musharakah</i> and <i>mudarabah</i> venture, the sources of funds from deposits are not allowed. Hence, only allows funding from Unrestricted and Restricted IA or shareholders' fund.	
(4) Profit and loss Sharing Ratio (PSR) determination	Based on the estimated return on <i>musharakah</i> and <i>mudarabah</i> venture; Benchmark rate of return of the equivalent product; and estimated management or operational costs incurred by the managing partner in the managing <i>musharakah</i> and <i>mudarabah</i> venture.	PSR is pre-agreed and cannot be changed during the tenure unless there is an agreement of gradual review. The PSR can be agreed on a tiering basis. OJK allows 3 types of profit-sharing method, i.e. profit sharing, revenue sharing, net revenue sharing. The financing tenure and profit-share distribution based on the Islamic bank and customer agreement. There is no restriction on perpetual tenure.
(5) Tenure	The tenure must be specific. Any <i>musharakah</i> ventures that are perpetual in nature shall be subject to approval and assessment by BNM on a case-by-case basis.	The financing tenure and profit-share distribution based on the Islamic bank and customer agreement. There is no restriction on perpetual tenure
(6) Collateral requirement	Both <i>musharakah</i> and <i>mudarabah</i> ventures may require collateral or a guarantee. However, it shall only be liquidated in the event of misconduct ( <i>ta'addi</i> ) or negligence ( <i>taqsir</i> ) or breach of specified terms ( <i>mukhalafah al-shurut</i> ) of a contract by the partner(s)	Islamic Banks may require collateral, which could only be liquidated in the event of misconduct, negligence, or any breach of the pre-agreed agreement.



Source: (BNM, 2015a, 2015b; OJK, 2015)

*Mudarabah* is a necessary form of operation for Islamic financial organizations. It provides the foundation for doing business by pooling cash and knowledge from diverse groups of individuals. However, *mudarabah* is seen as an extremely high-risk financing activity on the asset side, owing to moral hazard, adverse selection, and banks' lack of knowledge in project appraisal and associated technical concerns. Islamic banks may employ *mudarabah* to support the businesses of persons competent in labour, whether they are professionals such as doctors or engineers or dealers and artisans. It may also be utilised to finance overseas commerce without posing a significant risk of loss.

Islamic banking's fundamental concept is straightforward. Islamic financial institutions operate primarily on a PLS basis. An Islamic bank does not charge interest but instead shares in the profits generated by using money. Depositors also partake in the bank's earnings at a fixed rate. Thus, an Islamic bank forms a partnership with its depositors on the one hand and with its investment customers on the other, functioning as a manager of depositors' resources for productive purposes. This contrasts to a typical bank, which primarily borrows money at interest and loans funds at a profit on the opposite side of the balance sheet. The difficulty of Islamic banking stems from the diversity (and terminology) of instruments used and from a comprehension of Islamic law's principles.

In debt financing contracts, especially *murabaha*, to operate it in Islamic banks, some requirements must be fulfilled. Firstly, the subject of sale must exist at the moment of purchase. Secondly, the seller must own the item being sold at the time of purchase. Lastly, When the seller sells anything to another person, the seller must have physical or constructive ownership of the item (Brian Kettell, 2011).

Meanwhile, in the Equity financing products, especially *mudarabah*, Banks act as entrepreneurs (*mudarib*), while the client acts as the capital provider (*rabb al-mal*). Before establishing a *mudarabah* partnership between two partners, the customer acquires funds from the bank using the *Qard* idea, which serves as the *mudarabah* capital. Once the *Mudarabah* agreement is signed, the *mudarib* (bank) designates the client as its agent in the *mudarabah* enterprise through a *wakalah* agreement. Under the premise of forwarding *ijarah*, the person seeking to rent the property pays a predetermined sum as part of the future rental throughout the building phase. Following completion, the renter pays rent to the *mudarabah* enterprise under the *ijarah* concept. The following essential points should be considered when Islamic banks enter into loan agreements under the *mudarabah* facility: initially, the loan agreement should be independent of any inter-conditional contracts and should be indicated separately from all other financing contracts; second, banks should not charge customers any additional fees other than the accurate price of entering into the loan agreement; and third, the loan repayment should be. The mechanism for determining the monthly payment and the bank's profit/rental will be explored in more detail later (Azaheem & Aswer, 2019).

## OPERATION AND APPLICATION IN THE IFIs

Equity-based *mudarabah* and *musharakah* financings are preferred because they simulate the organisational structure of purely Islamic banks. However, due to the high level of risk and low level of tolerance for risk that is typical of a bank, very few banks are able to handle equity-based financing. It's true that investors seek returns on their capital that are between moderate and high, while also reducing the amount of money spent on risk and running the business. Therefore, many banks are wary of equity-based lending due to the dangers involved and the possibility of a decline in equity. When providing consumer financing, Islamic banks, as per the Islamic Financial Services Board (IFSB), favour exchange-based contracts over equity-based ones. Equity-based contracts make up less than 5% of Islamic banks' total funding. Over 20% of all Islamic financing around the world is conducted through *tawarruq* and *murabahah* contracts. It proves that Islamic financial institutions aren't able to withstand the dangers posed by capital impairment, information asymmetry, and inadequate monitoring and control.

Islamic financial institutions vary in how they use IAP financing mechanisms of *mudarabah* and *musharakah*. One of these "Restricted Investment Account through IAP" is provided by Bank Islam Malaysia Berhad (BIMB), and the investor enter into a *wakalah* contract. In a *wakalah* agreement between BIMB and the investor, BIMB takes on the role of the investor's agent. The bank extends funding to the company, which is typically structured as Islamic currency swap agreements. As per the *wakalah* agreement, BIMB will split both interest and principal with the

business after it is paid. If the business fails before the instalment is paid in full, there will be no profit to distribute to investors (Yustiardi et al., 2020).

In Pakistan, debt financing arrangements are used by the vast majority of Islamic Financial Institutions (IFIs). According to data from the State Bank of Pakistan in 2015, 70.54 percent of all financing was invested in fixed-income instruments like *murabaha* (cost plus selling transaction), *ijarah* (Islamic lease), and declining *musharakah* (underlying contract of which is *ijarah*, giving the banks fixed rentals). 11.39 percent of all funding went to *musharakah*, primarily to operate *musharakah*, while the remaining 17.99 percent went to other forms, such as *salam* and *istisna'*. Banks' indifference to social conduct for the weaker segments of society is illustrated by the fact that compassionate financing methods like *mudarabah* (a type of partnership in which two distinct partners and business profits provide capital and management is shared) and *qard hasan* (an interest-free loan) accounted for only 0.05 percent and 0% of total financing, respectively (Khaleequzzaman et al., 2019).

When it comes to Islamic financial institutions in Indonesia, Bank Syariah Bukopin is another option for securing *mudarabah* financing agreements (BSB). Individuals and companies alike will have use for this product long after the project is completed. To formalize their relationship, the bank and client sign a *mudarabah* contract. All funding comes from the bank, and customers serve as managers who receive a percentage of the profits based on the profit split agreed upon in advance. The company is required to provide collateral to the bank in the amount of 125% of the financing amount (Bank Syariah Bukopin, n.d.-a). The sale of financing products under *mudarabah* and *musharakah* contracts exposes Islamic banks to a number of additional risks, as evidenced by these practises, making Islamic banks less attractive. Malaysian and Indonesian Islamic financial institutions have both tried but failed to meet this demand. Yet there are unique challenges involved in putting it into practise. Despite IAP Malaysia's best efforts to promote risk-sharing among investors and business owners, the Islamic bank still prefers exchanging cash for ownership stakes in projects. Yet many Islamic banks in Indonesia have issued such financing agreements. However, the terms are similar to those of exchange-based financing agreements, such as the need for collateral and set repayment terms (Yustiardi et al., 2020).

Since *murabaha* is widely used by Islamic banks around the world, it is the most common and widely used form of Islamic financing in IFIs. According to some estimates, *murabaha* accounts for as much as 80% of all financial dealings made by Islamic banks. Since *riba* is forbidden by Sharia law, the alternative mechanism of *murabaha* was developed so that banks could still make a profit by lending to customers. The bank, rather than lending money to an interest-bearing borrower, purchases the asset or commodity in cash and then sells it to the prospective client at a predetermined profit. Since the client would not have participated in the transaction had he had the necessary liquidity to acquire the products outright, the bank allows the client to delay payment, in contrast to a conventional buy and resell transaction. That way, the customer can get their hands on the asset quickly without having to pay for it in full, and the Islamic bank can make a profit from sourcing the commodity. There are a number of conditions that must be met before this sale can be considered legitimate under Islamic law. For this reason, *murabaha* is based on the concept of interest prohibition, allowing members to earn interest-free profits and fees from the sale of assets or property (Sahthees et al., 2018).

*Murabaha* is a legitimate form of sale, but it becomes problematic from a shariah compliance standpoint when it is adapted to serve as a financing tool. A survey of the relevant literature demonstrates that the identified problems are shared by all IFIs around the world. All the issues highlighted in the report are serious and could threaten the stability of the IFIs. Penalties and rescheduling have been the subject of numerous articles, each of which has proposed their own set of solutions. Nonetheless, the issue of benchmarking remains contentious and unresolved among academics (Sahthees et al., 2018).

When it comes to conventional banking and finance, *qard* (loan) plays a crucial role. *qard*, in its many guises and garbs, is essential to the survival of any profit-driven financial institution. In spite of the fact that *qard* is fundamental to virtually all interest-based financial instruments, Islamic financial institutions (IFIs) make a concerted effort to avoid the term *qard* when referring to their offerings. IFIs primarily avoid *qard* because they do not want to be associated with *riba*. *qard*, "which is otherwise a means of virtuous virtue," becomes a sensitive matter "if advanced to obtain monetary gain" from a shariah perspective. As a matter of fact, the Islamic *qard* doctrine leaves little room

for asserting any kind of financial or non-financial gain from the instrument on the basis of the *qard* contract itself (Mohammad Abdullah, 2015).

Debt-based financing contracts are typically sought out by Islamic Financial Institutions (IFIs). In addition, the low-risk nature of debt-based financing contracts makes it possible for customers to swiftly satisfy all contract requirements. Conversely, international financial institutions tend to avoid using equity financing agreements out of caution. There are fewer preferred equity financing contracts because of numerous obstacles. IFIs' reluctance to fully implement equity financing products can be attributed to a number of factors, including asymmetry of information, moral hazard, a lack of knowledge and awareness, and high risk.

### 3. RESEARCH METHODOLOGY

The research was done mostly through the use of literature reviews in this study. We gathered information through library research to better comprehend the concept of equity and debt financing systems. To supplement the discussion of products and issues relating to equity and debt-based financing contracts in Islamic banks, a step-by-step process is used to collect and analyse data from various sources, including journal articles, research papers, public information from banking institutions, and regulatory and legislative provisions.

### 4. DISCUSSION AND FINDINGS

Based on library research acquired from earlier studies that addressed Islamic finance products, particularly debt and equity-based financing, this section discussed arguments and the current issue surrounding debt and equity-based financing. Debt and equity financing were both considered in the context of an Islamic finance case study by Yusof et al. (2009), who ultimately concluded that both types of the financing were acceptable according to *maqasid shariah* (Objectives of Sharia). A central question he set out to answer in his study was this: "...Are these debt-based contracts a realistic option for achieving Sharia compliance and economic fairness, or are they just mirror copies of ordinary debt financing products with bad societal consequences?" He argued that debt-based financing does not add anything to the conversation about a vision that takes into account the needs of society.

Khan (2015) analysed the differences between debt and equity financing to show how each would fare in a recession. This study set out to quantify the two funding products by examining a wide range of underlying philosophical and empirical assumptions. It covered how inflation, interest rates, and currency creation all play a role. The study demonstrated the significance of the impact of debt-based financing and risk transformation on the overall risk profile of an economy. It emphasizes *wakalah-ju'alah* as an alternative to debt financing and emphasizes the use of equity financing instead of debt financing. Risk-sharing agreements (*musharakah* and *mudarabah*) are also discussed, as is the dearth of these types of contracts in the Islamic financial sector.

On the other side, Islamic microfinance institutions all over Indonesia, (Fianto et al., 2018) looked into how this sector has influenced the financial security of rural households. The study compared the outcomes of equity-based and debt-based Islamic microfinance financing products for low-income rural families. Sharia compliance was evaluated in accordance with Indonesia's National Sharia Board's standards. Nonetheless, the result demonstrates that both loan and equity-based financing have a positive and substantial effect on the income of rural families. However, unlike debt funding, equity financing calls for higher performance expectations.

Relying upon debt-based financing provided by financial institutions may result in an individual losing his or her employment while repaying short- or long-term debt. This is the result, and it affects both people and companies since debt is a cost. As costs increase, businesses will attempt to reallocate resources by terminating certain workers, in most instances to save money, and no door will be created for the prospective and skilled individual to be employed. On the other hand, equity-based financing promotes job stability and opportunity. As expected, returns increase, financiers and investors will be motivated to employ more workers in order to maximize profit ethically and legally as prescribed in Islamic commercial law relating to Islamic transactions, comfort the *maqasid shariah* (Sharia objectives), and uphold the *maslaha* principle (public interest). The primary objective of any economic operation is to adhere to shariah standards and conditions included within the contract (Yusof et al., 2009).

According to (Maikabara et al., 2020), All of the problems associated with debt-based financing will affect GDP and, as a result, society's well-being. Because of the mountainous debts and the restriction of financial returns in one direction, rather than on a circulated parameter within the country as a whole, only the financier will benefit, while the debtor will only have a debt nightmare. In comparison, investing in equities increases the GDP, hence promoting economic growth and development. Their study demonstrates that equity-based financing may help assure the Islamic financial system's efficiency and sustainability, hence promoting socioeconomic growth. Additionally, equity-based financing is more conducive to the Islamic financial system's efficiency in achieving Sharia goals. In this context, policymakers must take proactive steps to encourage equity-based financing in order to secure the Islamic financial system's effective contribution to socioeconomic growth and sustainability. They strongly advocate for the integration of financial technologies (i.e., Blockchain, IoT, AI, and smart contracts) into equity financing products as a means of addressing the challenges impeding the products' promotion and realizing its potential for attaining sustainable socioeconomic development.

The majority of Islamic financial institutions prefer debt financing contracts to equity financing agreements. A total of 482,274,000 BD in *murabaha* and 89,239,000 BD in *musharakah* were financed by Bank Islam Bahrain in 2020, as stated in the bank's annual report. And according to Bank Muamalat's 2020 annual report, the majority of the bank's sharia-compliant financing came in the form of debt, with *tawarruq* accounting for 79.46% of that total. This unequivocally proves that Islamic banks prefer debt financing contracts like *murabaha*.

(Yustiardi et al., 2020) have argued that the use of equity financing contracts in IFIs is hampered by a number of problems and difficulties. Due to high risk, asymmetric information problems, moral hazard, and a lack of capital guarantee, Islamic banks have been unable to implement fully equity-based financing contracts. This led them to suggest more research was needed into the topic. Based on their findings, they suggest revising common assumptions about Islamic banking practices. These do not always need to mirror those of conventional financial institutions. Islamic banks, unlike their conventional counterparts, are required to share risk with their customers rather than pass it on to them in order to earn a higher return. Thus, an all-encompassing Islamic risk management system is necessary to reduce risk without compromising adherence to shariah principles. Therefore, there is no doubt that debt financing contacts play a role in increasing the profitability of banks. However, equity-based financing contracts are more profitable than debt financing contracts.

### **Current Issues of Equity and debt-based transactions**

#### **Issues related to equity-based transactions.**

##### **High Risk**

Commercial establishments with a low risk profile are preferred by financial institutions. Contrary, banks see *musharakah* and *mudarabah* as high-risk investments. As a *rabbul mal* (capital supplier) or *musharik*, Islamic banks face a number of risks (partnership). However, financial risk, business risk, and rate of return risk are three factors that may significantly influence an Islamic bank's decision to apply PLS in their financing. The principles of *musharakah* and *mudarabah* are similar in that they require partners to split both the gains and the losses. Thus, Islamic banks are wary of providing loans, as the money will likely come from customers' deposits who have faith that the funds, they deposit will be safe. As a precaution against the possibility of future losses, Islamic banks are obligated to take care of their customers' money themselves. Financial institutions care only about profit sharing and not loss sharing. In other words, they want everything that would reduce their losses and increase their profits (Yustiardi et al., 2020).

In light of the concerns expressed by authors in a number of different studies on this issue, in considering this matter further their findings, we see that the high risk may make *musharakah* and *mudarabah* less desirable. Therefore, *musharakah*-based financing is not widely available to customers due to the relatively high risk involved, as stated by (Rahman & Nor, 2016). Islamic banks need to compete with conventional banks, which are more well-established and therefore more competitive, according to (Humayatun & Presley, 2000), further bolstering this issue. In Malaysia, Islamic banks are hesitant to adopt the new *musharakah* system due to the high risk it poses (Kamarulzaman & Madun, 2012). Therefore, due to the high risk involved in financing equity-based contracts, Islamic banks prefer



debt-based contracts instead. Depositors provide the funds that Islamic banks use to operate. As a result, Islamic financial institutions cannot support *musharakah* and *mudarabah* due to the high risk involved and the need to maintain the confidence of their depositors. This problem was also mentioned by (Maikabara, 2019) in his article.

### ***Asymmetric Information***

Although, *musharakah* and *mudarabah* are fully implemented, Islamic banking is facing a number of challenges, one of which is asymmetric information. In all possibility, the majority of *mudharib* in *mudarabah* will still have access to sufficient and supplementary data regarding the project. However, Islamic banks will be left out of the project's financial benefits. Because of this, there will be tension between the two parties (Sapuan, 2016). Distrust between Islamic banks and their clients stems from information asymmetry. Muslim financial institutions are discouraged from implementing *musharakah* and *mudarabah* because of Asymmetric information.

We believe that asymmetric information causes distrust and misunderstanding between Islamic banks and their customers, which may result in loss for both parties of the contracts, based on our review of the literature on issues of products offered by Islamic banks. As a result, Islamic financial institutions favour projects where there is full faith and trust between all involved parties and only then finance the products. This is an issue that has been raised along with a large number of studies. According to (Naim et al., 2016) Islamic banks are hesitant to adopt *musharakah* and *mudarabah* due to asymmetric information that arises from the use of *musharakah*, *mudarabah*, and other equity-based contracts.

### ***Capital Guarantee***

Depositors provide the majority of a bank's funding. Assuring the security of capital is crucial in the event of a default or other loss. This promise shows their seriousness and commitment to preserving the Islamic banking system. As a result, moral hazard and fraud may be reduced if collateral is used as a form of assurance. Unfortunately, the capital-poor partner may not be able to provide the necessary guarantee because of the request for credit. Thus, it shows the challenge that must be carefully considered before Islamic banks implement *Musharakah* and *Mudarabah* (Yustiardi et al., 2020).

We see that the lack of customer capital guarantees and collateral is a significant barrier to implementing *musharakah* and *mudarabah*. In general, Islamic financial institutions stipulate conditions that must be met prior to project launch. Obtaining financing for equity-based contracts is contingent upon securing a capital guarantee. Unfortunately, some of Islamic banks customers are unable to meet this requirement. Therefore, without assurance of sufficient capital, the bank cannot move towards equity financing contracts. According to what the authors of the aforementioned their article (Abdul-rahman & Nor, 2017).

### ***Lack of Awareness and Knowledge of The Equity-Based Products***

The debt-based contracts is the most widely used by Islamic financial institutions (Maikabara et al., 2020). The authors have already emphasized how the equity-based financing products is the most applicable. Customers, however, continue to place orders with Islamic banks for debt-based financing contracts. The general public's unfamiliarity with equity-based compensation is largely to blame for its low adoption rate. It is the opinion of the authors that the advantages of equity-based financing over the debt-based contracts are underappreciated.

The research of (Fianto et al., 2018) lends credence to this concern. Based on several studies that examined the lack of awareness and knowledge of the equity-based products. Therefore, we agree that the general public's lack of familiarity with equity-based financing is a major factor in its unpopularity. Since fewer people and organizations are familiar with the equity-based contracts compared to the debt-based financing contracts, its use is lower. Moreover, people, especially those with lower and middle incomes cannot quickly fulfil the essential elements of an equity-based products.

### ***Issues Related to Debt Based Transactions***

#### ***The Difference in Pricing for Cash and Credit Sales***

A committee of jurists has ruled that any rise in price resulting from postponed payment is illegal. The majority of jurists, however, approved of this rise. They contend that the broad interpretation of Allah's statement "And Allah authorized the sale" is "And Allah permitted the selling." Because selling for a future price higher than the cash price is not explicitly prohibited, it will remain permissible.

In our view, increasing the *murabaha* price due to postponed payment is legal and does not violate any sharia regulation. This is justified by the *murabaha* price growth due to postponed gain is secondary to commercial operations through trade. Still, the increase in debt is due to credit activities, which increase money on money. As a result, the price increases in debt and trade are opposed. However, *murabaha* payment is the complete amount of the items supplied in one transaction, while the delayed payment is only a convenience offered to clients to pay in instalments. Additionally, typical loan or instalment payments are compounded. This is the decision of the OIC's Fiqh Academy No. 51 (2/6). A similar issue has also been described in (Sahthees et al., 2018) study.

### **Imposing penalty on default payment**

Credit facilities given by conventional banks are typically secured by the interest compounded over time. If the customer does not repay the loan before the maturity date, the interest burden increases. Along with improving the lender's revenue, this method functions as a disincentive to defaulting. In the Islamic system, since the *murabaha* price is determined at the start, the client's responsibility cannot be increased as a result of a delay in settlement. The financier is only entitled to the first *murabaha* price, regardless of when it is paid. Consequently, some customers may delay payment to take advantage of the free credit term. If the delay is intolerable, occasionally severe punitive interest rates are imposed. This dilemma might be resolved in a world where all financial institutions offer only Islamic services since defaulting customers may be block listed and denied future benefits. This, nevertheless, could only be accomplished with the collaboration of all banks (Sahthees et al., 2018).

With regards to this issue as discussed by many authors in several articles, we believe that imposing a penalty on default payment due to delay instalment is a *Riba* OIC's Fiqh Academy passed a resolution on its prohibition it states that if the debtor (buyer) delays paying the instalments beyond the specified date, it is not permissible to oblige him to pay any increase in the debt, with a previous condition or without any condition, because that is usury which is forbidden (IIFA, Resolution 51, 2/6).

Imposing a penalty on default payment is a current issue that affects debt financing contracts. However, the problem still remains how Islamic banks can mitigate default risk without any penalty or any effective tools. In our point of view, IFIs may seek an undertaking that if the customer having ability of payment, defaults instalment payment on its due date, he will be penalised a certain amount as penalty which will be given to charity under the supervision of the IFI's shariah board. IFIs are not allowed to recognize these penalty charges as income. Having said that, in our judgment those who delays due to inability and poor financial condition, nothing shall be taken from them as penalty because Allah says: "If the debtor is in difficulty, then delay things until matters become easier for him; still, if you were to write it off as an act of charity, that would be better for you, if only you knew" (Al-Baqra: 280).

### **Rescheduling for Additional Payment:**

When a customer cannot pay on the dates specified in the *murabaha* agreement, he/she may request that the seller/bank reschedule the payments. Occasionally, delaying instalments is seen as a way out of default. In a conventional bank, rescheduling a loan entails an extra interest fee to account for the schedule variations. This is not available while playing with *murabaha*. Such rescheduling is not permitted in *murabahah* since no further payment may be levied. However, no extra fee for rescheduling may be imposed if instalments are postponed. The *murabaha* price will stay constant. Certain banks seek to get around this by modifying the currency unit. This is, of course, not acceptable. They advocated rescheduling the *murabaha* price in a currency different from the one used in the first transaction (Sahthees et al., 2018).

In response to the finding of several studies, we agree with the authors because *murabaha* in Islamic banks follow shariah law s which prohibits any additional amount in *murabaha* payments and considered as *riba*. As the authors mention in conventional banking, loan rescheduling is accompanied by an additional interest charge. But

rescheduling *murabahah* payments in Islamic banking is not allowed as no additional amount can be charged for the same. The amount of the *murabaha* price will remain unchanged.

### ***Rebate in Case of Early Payment:***

Usually, debtors want to pay immediately to get discounts, likewise with conventional banking. The question here is whether the Islamic banks provide a value for early *murabaha* payment, and how shariah schools respond to this case. The ancient jurists addressed this problem in depth. They determined that since *murabaha* constitutes the sale of an actual item - the established price - there can be no rebate or reduction for the buyer's early payment. The topic is "*Da'wa ta 'ajjal*" in Islamic legal literature (Give discount and receive soon). While some older jurists (including the *Shafi'i*s, *Hanbali*s, and *Tbadis*) have defended its permissibility, most Muslim jurists, including the four schools of Islamic law, particularly the *Malikis*, categorically condemn it and deny remission (for earlier payment in *murabaha* operation by banks). According to certain jurists, early settlement is not acceptable if linked to a discount. However, if the refund is not an inducement to prepay and is not seen as a need for early payment, and the bank makes the concession willingly, it may be permitted under Sharia (Sahthees et al., 2018).

Regarding this issue, in our point of view we agree that early payment is acceptable. However, we disagree that early payment should be connected to a discount, which is unacceptable as many prominent Muslim scholars argue. Furthermore, we agree that the loan can be paid early if there is no intention toward discount. A similar issue has been highlighted by (Sahthees et al., 2018).

### **GAP ANALYSIS**

Islamic equity-based financing and debt-based financing contracts are two of the most significant Islamic products and services IFIs offer. The debt-based financing contracts is the most common financing contracts customers prefer. However, the debt-based financing contracts is not more effective in bringing more profitability to Islamic banks and customers than the equity financing products. An equity-based financing product is more effective than debt contracts. Because it increases the wealth of Islamic banks and customers, it also plays a significant role in reducing poverty. Nonetheless, equity-based agreements are not standard in Islamic Financial Institutions (IFIs) due to a lack of knowledge of the bank's employees, lack of awareness among Muslims communities, asymmetric information, high risk, lack of capital guarantee, and strict regulations when applying equity contracts. These challenges have created a problem for the application of equity-based financing products.

Furthermore, there is a lack of literature on resolving equity-based contract concerns, even though Islamic banks use equity-based contracts as the primary contract and commercial transaction. While issues have been identified, the solution section requires further study and effort to ascertain the answer to the *mudarabah* and *musharakah* contracts discussed in this research paper. While debt-based transactions such as *murabaha* need more analysis to establish an Islamic profit benchmark for *murabaha* pricing and to develop a unique debt-based financing solution.

## **5. CONCLUSION AND RECOMMENDATION**

Equity-based financing and debt-based financing are the two prominent Islamic financing instruments. While equity-based financing is an investment that deals with tangible assets, many parties agree to the project by specifying proportions or management of the partnership, risk-sharing, and identifying that profit and loss will be shared according to the balance of capital invested. Debt-based financing is a mode of financing for specific contracts where both sides are fully ready to sign the contract. This mode of financing is a sale transaction. Car financing, house financing, makeup sale, advance sale, manufacturing sales, and many other financing types are under debt-based financing contracts.

The primary shariah requirements are that all debt and equity financing methods should be interest-free, uncertainties be avoided, and all gambling and alcohol-related businesses be outlawed entirely. Furthermore, contracts must be transparent and complete in terms of mutual agreement between the parties involved. The debt financing contracts is the most common contracts preferable among people and Islamic banks. Debt financing has no hard limitation when the customer requests to the bank, on the other side, the bank cannot feel high risk when offering a debt-based financing contracts.

Meanwhile, the equity-based financing contracts is the best one in terms of profitability and poverty reduction. However, asymmetric information, excessive risk, a lack of capital security, and other obstacles make Islamic financial institutions less desirable. Nonetheless, more research and study into these issues is critical in the current context, and also, more social awareness is essential to overcome these challenges and obstacles.

Moreover, governments should encourage and establish a long-term strategy to convert toward equity financing and enhance the ratio of equity-based financing products. As a result, it may aid in the achievement of the Sustainable Development Goals (SDGs) since it is a socially responsible and value based.

Furthermore, we advocate for the use of technology in Islamic banking institutions. It is well known that technology has laid the groundwork for the expansion of financial services. The new Fintech platform provides a creative way to sell products and services with a more customer-centric experience than previous methods by combining speed and flexibility abilities (Nicoletti, 2017). Fintech platforms could improve transparency and sustainability by accelerating the financial process from diverse types of investors, hence supporting Sustainable Development Goals. Individual investors could only make direct investments in the actors' proposed fund through a FinTech platform. A fintech platform might also handle asymmetric information, allowing institutional investors to obtain data and borrower information more precisely with the help of cutting-edge technology. Utilizing fintech in Islamic banking products could thereby lessen the problems and challenges of Islamic banking products (Lynn, Mooney, Rosati, & Cummins, 2019).

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