International Workshop

EXPLORING ISLAMIC ECONOMIC THEORY

AUGUST 11-12, 2008 (9-10 RAJAB 1429H)
UNIVERSITAS ISLAM INDONESIA
YOGYAKARTA, INDONESIA

PROCEEDINGS

Edited by Abdul Ghafar Ismail • Achmad Tohirin • Munrokhim Misanam

Organized by:

UNIVERSITAS ISLAM INDONESIA

UNIVERSITI KEBANGSAAN MALAYSIA
National University of Malaysia

• Graduate Program in Economics, Faculty of Economics
• Centre for Islamic Economics Development & Studies (P3EI)

Islamic Economics & Finance Research Group (EKONIS)
School of Economics, Faculty of Economics & Business

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ISBN International 978 983 3198 221

PREFACE

From

Graduate Program on Economics and Centre for Islamic Economics Development Studies (P3EI)

Islamic University of Indonesia

Bismillahirrahmanirrahiim,

The most gratitude belongs to Allah who gives us the guides and spirit to understand and implement Islam, the right teaching.

Islamic economic has been rigorously developed for more than thirty years ago. Following this development, most Moslem scholars are concerned on discussion on the topic of Islamic Banking and Finance. As the result, this area has now well developed. On the other hand, little attention has been made on the other area of Islamic economics, e.g. Islamic theory of pricing, consumption, resource allocation and production and distribution. These areas, as the result, are lack behind compared to Islamic banking and finance. Indeed, Islamic economic need to have a strong theory on these areas. Therefore, there is a strong need to explore and develop the discipline.

To support this effort, Center for Islamic Economics and Development Studies (CIEDS), and Graduate Program on Economics of Islamic University of Indonesia collaborate with Islamic Economics & Finance Research Group (EKONIS) of the Universiti Kebangsaan Malaysia to establish Islamic Economics Forum aiming to promote the systematic development of Islamic economics. The first program is First International Workshop on Islamic Economics: Exploring the Islamic Economics Theory which is held at Islamic University of Indonesia, Yogyakarta, Indonesia on August 11-12, 2008. The theme of the workshop is "Exploring Islamic Economic Theory". The sub-theme of the workshop is developing Islamic economic methodology and exploring Islamic economic theory. In addition, some sub-themes are concerned on Islamic monetary economics. Altogether 24 selected papers are discussed at the workshop which are categorized to four themes, e.g. Islamic economics methodology, Islamic monetary and finance theory, Islamic microeconomics and Islamic public finance and macroeconomics.

This workshop is expected to bring the development of Islamic economics to the comprehensive roadmap, which is gradually preparing the complete theory on Islamic economics. The proceedings of the workshop are being published in two countries, Indonesia and Malaysia. We hope that the second round of the forum's agenda would take place and strengthen the previous steps. Moreover, we expect to have more Muslim scholars being attracted to participate in the development of the area in the future.

We also acknowledge several people, without their assistance this workshop could not be established; Mr. Zulian Yamit, the vice director of the graduate program on economics and Mr. Teguh Santosa who support us in preparing many technical assistances; Also Mr. Nur Kholis, Mr. M.B. Hendrieanto and Mr. Sigit Handoyo, who take care of the committee operation. Mrs Iin, Mrs

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KNOWLEDGE-BASED VIEW V.S. INCENTIVE-BASED VIEW

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Abstract

Most studies in Islamic economics and its proponents propose Profit-Loss-Sharing (PLS) system as the basic concept of the Islamic banking operation, however, current practices witness non-PLS financing contracts to be overly dominant. The most cited argument of the lacking of PLS financing is the agency problems (i.e. adverse selection and moral hazard). Studies that put more focus on agency problem in the form of agent's negative behavior are known as the incentive-based view (IBV). This paper tries to criticize the weaknesses of this view, which considers as a more dominant approach, aiming at improving the financing performance of banking institution. One of the negative impacts of applying IBV is too much reliance on collaterals for the banks in approving the credit/financing so they may overlook or less focus on profitability consideration of the project/business, known as lazy-bank hypothesis. This affects the degree of confidence of the Islamic bank managers to advance PLS financing. On the other hand, another approach emerges importantly to enhance the Islamic banks' capability based on knowledge to increase the quantity of PLS financing, known as knowledge-based view (KBV). This paper tries to compose a conceptual model combining both views.

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1. Introduction

During the past decade, the growth rate of Islamic banking exceed that of conventional banking making it one of the most dynamic areas in international finance (Ahmed 2006:45). Despite its sophisticated growth, Islamic banks have been criticised for focusing too heavily on low-risk financing such as murabahah rather than profit-loss sharing financing (henceforth PLS financing). The practices of Islamic banking show that the dominant contract for the financing activities is based on debt contracts while PLS financing are marginaly conducted (Iqbal and Mirakhor 2002).

One factor mostly cited by the writers concerning the lack of PLS financing practice is agency problems, i.e. moral hazard, as entrepreneurs have disincentives to put in effort and have incentives to report less profit or reluctant to report the true profit of financing (Sarker 1999; Dar & Presley 1999). To overcome agency problem, some writers argue that Islamic bank would have to conduct costly monitoring expenses to make sure that the declared profit reflects economic activities and entrepreneurs put more effort in managing the project. Ahmed (2006:18) stated that in conducting PLS financing successfully, Islamic bank requires banks to pay more attention to the day-to-day operation of business of its customers than conventional bank. The approach used in this paper focuses more on negative behavior of the entrepreneur (i.e. moral hazard) and characterised as the incenuve-based view (IBV).

The IBV is a dominant approach in achieving the quality of financing in conventional bank. Conventional banks receive a fixed return from certain financing causing them to concern more on the creditworthiness of their customers rather than the capability of customers in conducting business activities (Ahmed 2006:18). Although in selecting the proposal of financing, conventional bank theoretically using five-C criteria (*character, capacity, capital, condition* and *collateral* (Beaulieu 1994) or six-C criteria (*character, capacity, cash, collateral, condition and control* (Rose & Hudgins 2005:533), some writers argue that collateral which reflects customer's creditworthiness is the dominant factor in influencing the financing (Chan & Kanatas 1985; Bester 1985; Besanko & Thakor 1987 and Boot et al. 1991).

However, some writers also assert that the dominant use of collateral in financing process may have negative effect. For example, Bester (1985) argued that collateral availability eliminates credit rationing. In addition, Manove et al. (2001) stated the negative effect resulted from the use of collateral in financing i.e. bank would be reluctant in conducting the screening process, a phenomena known as *lazy-bank hypothesis*. In other word, if banks were to depend heavily on collateral, the capability of the bank in conducting feasibility study may be low.

On the other hand, Islamic banks deciding to apply PLS financing, has a direct interest in encouraging good managerial practices in the business of its customers. Islamic bank has to focus on the return of financing because its own profitability is directly linked to the real rate of return (Iqbal & Mirakhor 2007:112). Due to the fact that Islamic bank basically not using collateral, the capability of Islamic bank in conducting screening process become much more important (Ahmed 2006:40).

Discussion in this paper will focus on suggesting more broader approach to deal with the enhancement of PLS financing performance, which include knowledge-based view (KBV) as well as IBV. The role of knowledge in the banking industry is acknowledged since 1996 when World Bank president James Wolfenson suggesting the aplication of knowledge management in the banking industry (Cohen and Laporte 2004). In the context of Islamic bank, the role of KBV view is emphasized by Sarker (1999) and Octa Melia Jalal (2006).

The rest of the paper is organised as follows. First is reviewing of the concept of PLS financing; discussing briefly the advantage of PLS financing compare to debt-based financing. Second is analysing financing procedures practiced in conventional bank and describing some relevant empirical evidence. Third is describing theory of the firm based on KBV and IBV. Fourth is discussing the applications of IBV and KBV and fifth is concluding the paper discussion.

2. The economics of PLS

2.1. Basic Concept

PLS as a system basically embark from the concept of partnership and cooperation. It is participatory in nature, to drive cooperation among economic/business players to create value added by undertaking projects or business ventures. Value creation resulted from project might have several forms such as; the goods and services produced to fulfil the needs of the people; job opportunities created; allocation of resources by efficient utilization; etc. PLS mechanism enables capital providers, who have financial resources, and entrepreneurs, who have skills and creativity to undertake every profitable ventures but lack of capital, to match in business dealing based on the merit of each party without worrying any collateral. This mechanism may encourage new business creation and contribute to the community's economic development (Nienhaus, 1988: 24).

Contractual wise, PLS mechanism is applied mainly through two types of contract, mudharabah and musharakah. Mudharaba is a contract between two parties, one as capital provider (shahibul maal) and the other as entrepreneur (mudharib) to conduct business ventures. The contract requires both parties to arrange and fulfil their rights and obligations. Both parties should agree in advance for the profit share applied, whereas for any financial loss prevailed will be born only by capital provider. The entrepreneur will suffer the loss, unless negligence can be proven, only in the form of efforts and time spent unrewarded. Meanwhile, musharaka is a contract between two or more parties to conduct business ventures. Each party entering into this contract will contribute capital in the form of financial or non financial capital. The profit share and the distribution of losses will be determined up-front or prior to executing the business ventures.

Mudharaba and musharaka contracts have differences in terms of the form of capital to contribute. Mudharaba requires that capital should be in financial/monetary term. Hassan, Z, (1985) quoted that jurists generally agree that in *mudharaba* the PLS ratios of the financier are to be different and capital can be contributed in the form of money or money's worth. Furthermore, the financier has no right to participate in the business decision making (Ghazali, pp.84-85). On the contrary, musharaka allows capital to have non-financial forms, such as labour, and skills to enter into contract and all parties participating in the contract has the right to participate in making business decision.

The basic concept of PLS relies on the sharing aspect. In this regard what being shared by each party involved is the outcome of the business dealings which may be positive (profits) or negative (losses). Under this scheme the result sharing is negotiable and must be agreeable prior to the implementation of the projects. Profit Sharing Scheme, another varian of partnership aims at driving the employees to perform as productive as possible so that production efficiency might be enhanced. It reflects a kind of 'employee-employer relationship'. Whereas PLS scheme (musharakah) reflects more of partnership which requires residual sharing of the business ventures and it is implemented in the Islamic financial system to replace interest-based mechanism.

2.2. The Importance of PLS Financing

As asserted by Al-Omar and Abdel-Haq (1996) that along with distributive justice, the rationale for profit-sharing, implemented through PLS financing, also embraces allocative efficiency, economic stability and growth. Equitable distribution of risk and return attached to mudharaba and musharaka contracts might lead to important consequences. Financing based on these two contracts might enhance the level of investment due to prioritizing sound investment projects, rather than ability to repay the loans, when granting the financing, and hence improve the efficiency of resource allocation.

Presley, and Sessions, (1994) have shown that the use of the prevalent alternative method of financier remuneration (i.e. *mudarabah)* will, under certain conditions, lead to an enhanced level of capital investment on account of the ability of *mudarabah* to act as an efficient revelation device. By applying the ideas developed in the Western contract literature by Holmstrom and Weiss (1985) and Meyer (1986) they show that a *mudarabah* contract between a project manager and a syndicate of investors may permit a more efficient revelation of any informational advantage the manager may have over the latter.

As for the cost of financing, PLS financing may result in lower cost compared to interest based financing (Khan, W.M., 1987), it is also lower than that of markup financing (Al-Suwailem, (2008) and Abdul Ghafar and Tohirin (2008)). Consequently PLS financing is considered as a more efficient and effective mechanism in allocating the resources. Furthermore it may drive more positive impact in the micro and macro level of the economy.

In addition, some literatures argue that the quantity PLS financing must be increased (Chapra 1985; Abdus Samad & Kabir Hassan 1999; Habib Ahmed 2002). Significance amount of PLS financing is one of the objective of Islamic banks (Chapra 1985), because the high quantity of PLS financing reflects the commitment of Islamic banks on community development (Abdus Samad & Kabir Hassan 1999). Furthermore, Habib Ahmed (2002) asserts that quantity of PLS financing and debt-based financing should be balanced.

Based on the above discussion, it appears that the quantity of PLS financing is one the criteria of Islamic bank's performance. However, high quantity of PLS financing must be followed by high quality of financing, that is, non-performing financing (investment risk reserve) is relatively low. Accordingly, in this paper the performance of PLS financing will be looking into two aspects i.e. the quantity of PLS financing and the quality of PLS financing.

3. Lending Control Mechanism in Conventional Banks

As described above, the quality of lending in conventional bank are managed by five C's of credit including character, capacity, capital, condition and collateral (Beaulieu 1994). The character means management's determination to repay the debt. The concepts used to explain character are integrity, stability and honesty. Other than that defined character, it is also frequently and simply defined as honesty or integrity. The capacity is defined as management's ability to operate a business capable of repaying the debt. It is evaluated mainly through financial statement analysis; other factors (e.g. management's experience) are considered. The capital is the funds available to operate a business. To access capital, lenders determine the amount of equity investment and how effectively that investment will be used to generate cash flows. Financial statements are the primary source of information about capital. The conditions mean the prevailing economic condition (e.g. the business cycle).

Recently, 5C's criteria of credit have been extended to be 6C's of credit. For example, Rose & Hudgins (2005: 533-537) stated that before loans be extended to the customer, credit analysis is conducted based on 6C of credit, including character, capacity, cash, collateral, condition and control. Basically, 6C of credit is a procedure to determine the creditworthiness of the borrower. Character means that the customer has a well-defined purpose for requesting credit and a serious intention to repay. If the officer cannot be ensured exactly why the customer is requesting a loan, this purpose must be clarified to the lenders' satisfaction. Responsibility, truthfulness, serious purpose and serious intention to repay the loan content to what a loan officer calls character. Capacity means that loan officer must be sure that the customer requesting credit has the authority or eligibility to request a loan and the legal standing to sign a binding loan agreement. Cash means whether the borrower have the ability to generate enough cash to repay the loan. Collateral means whether the borrower posses adequate net worth or own enough quality assets to provide adequate support for the loan. Conditions refer to recent trends in the borrower's line of work and how changing economic conditions might affect the loan. The last factor in assessing the borrower's creditworthiness status is control, which centers on such questions as whether changes in law and regulation could adversely affect the borrower and whether the loan request meets the lender's and the regulatory authorities' standards for loan quality.

Based on that description, it appears that there are many criteria to assess the borrower's creditworthiness. Furthermore, each writer may describe the meaning for each criterion differently. Accordingly, the exact specification of the C's of credit varies among publications and in practical aspect may vary among banks. From the six factors which determining credit decision, collateral are found to be a dominant part of credit analysis.

Myers (1977) asserts that when risk of lending is high, collateral may play a disciplinary role in the behavior of the borrower. Collateral may play the role as a signaling device for borrower quality (e.g. Chan and Kanatas, 1985; Bester, 1985; Besanko and Thakor, 1987a,b; Boot et al., 1991). It may lower the agency costs of debt by preventing the problem of asset substitution (Jensen and Meckling, (1976), and Myers (1977) and mitigate underinvestment problem (Stulz and Johnson, 1985).

Furthermore, Chan & Kanatas (1985) argue that collateral improves lenders' estimates of their expected returns that is, collateral can serve as a source of additional, indirect information in a rational expectations signaling context. In addition, collateral provides a signal to the lender of the borrower's information. If the lender has a lower valuation about borrower's creditworthiness, the borrower has an incentive to offer higher collateral. Besanko & Thakor (1987) found that equilibrium credit rationing is possible even when collateral is available and deposit supply is perfectly elastic. While Boot, et al, (1991) show that collateral is a powerful instrument in dealing with moral hazard.

Although many authors argue that collateral is the important factor in credit analysis, some writer critize a negative effect of collateral. Bester (1985) argues that collateral availability eliminates credit rationing. Specifically, his model shows that investors with a low probability of bankruptcy are more inclined to accept an increase in collateral requirements. Collateral is commonly known as "second way out" and is generally viewed as vastly inferior to positive cash flow as a method of repayment. Collateral alone should not be used to justify making a loan (Ruth, 1987). In addition, Manove et al. (2001) develop model which is called *lazy-bank model*. They criticize the unrestricted reliance on collateral and argue that this might have a negative impact on credit-market efficiency. They argue that banks are in a good position to evaluate the future prospects of new investment projects. Collateral will weaken the bank's incentives to do so. Especially for small firms, banks would do little screening and rely excessively on collateral. From the point of view of banks, collateral and screening can be considered as substitutes.

By using 5 or 6C's of credit, financial statements of the borrower are essential to credit analysis because they are used to judge capacity and capital, which together with conditions will determine whether debtors can produce operating cash flows sufficient to repay their debts (Beaulieu 1994). Some researches on the credit decision focused on the role of financial statement in the lending decision. In his empirical study, Deakins (1994) found that credit officer focusing on financial information compare to information concerning management skill of the customer. This finding supports the role of collateral or the asset owned by the customer in affecting lending decision. Furthermore, Beaulieu (1994) found that experienced credit officer may not conduct screening process concerning character and management skill of the customer in case financial report indicates poor performance.

4. Theory of the Firm: Incentive-Based View

Advances in the theory of the firm have been dominantly influenced by neoclassical economics. Theory of the firm from neo classical economics mostly dominated by the nexus of contract theory or positive agency theory (Jensen and Meckling 1976) and principal agent theory (Ross 1973). Some authors called both theories simply as agency theory (Eisenhardt 1988; 1989; Baiman 1990; Ekanayake 2004). Agency theory (Jensen & Meckling 1976; Rose 1973) is directed at a particular type of organizing problem i.e. agency problem. It models the relationship between a principal who delegates work to an agent who perform that work. Agency theory attempts to describe that relationship using the metaphor of a contract. The focus is on determining the optimal contract that governs the relationship between a principal and an agent (Eisenhardt, 1988).

Generally, agency theory argues that agents are opportunistic and will always engage in self-serving behavior if opportunities arise. Accordingly, the role of governance system (control system) (e.g. structure, procedures, information systems, rewards and penalties) is to help principals in curbing opportunistic behavior of agents by reducing opportunistic behavior. Agency theory is concerned with the agency problem that exists when there is an agency relationship. The agency problem occurs because the agent has goals that are different from the principal (Jensen and Meckling 1976; Ross 1973).

Verstegen (2001) added that agency theory deals with implicit and explicit arrangements between one or more principals and agents in a situation of information asymmetry. Agency theory is based on rational choice behavior by agents and principals who depend on each other but who strive for divergent goals. Agency theory attempts to resolve two problems relating to the agency problem. The first is the monitoring problem that arises because the principal cannot verify whether the agent has behaved appropriately. The second is the problem of risk sharing (particularly in the case of outcome-based controls) that arises when the principal and the agent have different attitudes towards risk (Eisenhardt 1989).

5. Knowledge-Based Theory of The Firm

If agency theory is dominantly influenced by economics, KBV mostly based on management literatures, mainly in the organization and strategy fields. Knowledge-based theory of the firm argue that the performance of a firm depend on the concept such as capabilities, dynamic capabilities or competence.

Contributions to the KBV are usually launched on a background of critique of new institutional economics. The critique concerns the reliance on opportunism and the neglect of differential capabilities (i.e., firm heterogeneity) and dynamics capabilities (e.g. Winter (1988); Langlois (1992); Kogut and Zander (1992)). In contrast, contributors to the KBV typically begin with the empirical generalization that firm-specific knowledge is sticky and tacit and develop through path dependent processes. This implies that organizations are necessarily limited in what they know how to do well. Thus, knowledge-based writers argue that a theory of the firm should be based on considerations of knowledge, rather than incentives and opportunism.

Knowledge-based writers also claim that the existence of the firm can be explained in knowledge terms and without invoking opportunism (Hodgson 2004). Demsetz (1988) argues that firms exist for reasons of economizing on expenditures on communicating and coordinating knowledge. Thus, the employment contract, and hierarchy more generally, may exist because it is efficient to have the less knowledgeable being directed by the more knowledgeable.

From strategic management perspectives, the role of knowledge in determining firm performance is based on the argument of *resource-based view* (Wernerfelt 1984). RBV argue that the firm exists because of providing economies of scale, through their own resource. If agency theory focuses on reducing agency problem, focal point of RBV is on the production activities in raising competitive (Grant 1991). RBV has the objective to observe the production process deeply, in which that production process in economic theory is viewed as the black box (Spender, 1996).

Resource is anything which could be thought of as a strength or weakness of a given firm (Wernerfelt 1984). More formally, a firm's resources at a given time could be defined as those (tangible and intangible) assets which are tied semi permanently to the firm. Examples of resources are: brand names, in-house knowledge of technology, employment of skilled personnel, trade contacts, machinery, efficient procedures, capital, etc. The most important resource in RBV is knowledge. Accordingly, RBV are developed further and well known as knowledge-based theory of the firm (Spender 1996). The role of knowledge in raising firm performance is also acknowledged by other disciplines such as psychology, anthropology, sociology and human resource management. Currently, knowledge management is known as multi disciplines (Jashapara, 2004).

6. The Solution of PLS Financing's Problem: Incentive-Based View

Studies emphasizing incentive-based view (IBV) mainly use agency theory framework to design mechanism for controlling negative behavior of the agent. Accordingly, the success of the use of PLS financing will depend on the resolution of the problem of asymmetric information associated with their use.

Some authors suggest **incentive-compatible constraint** may reduces agency problem both adverse selection and moral hazard. There are four mechanisms in incentive-compatible constraint such as higher stake in net worth (collateral); high operating risk firms have higher leverage; lower fraction of unobservable cash flow and lower fraction of noncontrolable cost (Karim 2002). Concerning those mechanisms, Ahmed (2002) argued that moral hazard problem could be reduced using assets of the entrepreneur as collateral that can be used to punish false reporting by the firm to minimize the problem. Concerning adverse selection problem the writer suggests choosing firms that are relatively established and have had previous dealing with the bank. Karim (2002) also support that collateral may reduce moral hazard problem in PLS financing. Besides collateral, the writer also examined another mechanism in incentive-compatible contract which may reduce moral hazard problem in PLS financing including high operating risk firms have higher leverage; lower fraction of unobservable cash flow and lower fraction of noncontrolable cost.

Another authors examined that PLS performance could be increased using monitoring system (Ahmed 2006: 49; Hudayati & Auzair 2008). Effective internal control and accountability mechanisms need to be developed along with appropriate risk management strategies (Ahmed 2006:49).

Hudayati & Auzair (2008) emphasizes the use of management control system, namely performance measurement system to increase PLS performance. They (2008) argue that the behavior of Islamic bank may affect the performance of PLS financing. Accordingly, control system used to influence managerial behavior known as management control system may increase PLS performance through reducing agency problem. In their model, agency problem done by Islamic bank is measured using attitude toward risk. Generally, their findings indicated that there is a significant positive relationship between diagnostic use of PMS and attitude toward risk and there is a significant negative relationship between interactive use of PMS on attitude toward risk. Consequently, diagnostic use of performance measurement system may reduce agency problem in PLS financing. In addition, their findings indicated that there is a negative relationship between attitude toward risk and the quality of PLS financing whereas the hypothesis concerning positive relationship between attitudes toward risk on the quantity of PLS financing could not be supported. With regard to direct relationship between performance measurement system on PLS performance, their findings indicated that both interactive use of PMS and diagnostic use of PMS significantly affect the quality of PLS financing.

Khalil et al (2002) studied factors influencing bank in accepting or rejecting mudharaba financing, using questionnaire survey method. Their study found that project attributes, the quality of the entrepreneur and the religious considerations are the three most important factor in affecting bank to accept or reject PLS financing. By using their finding, bank managers may use the result in order to design strategy for reducing agency problem; for example to identify good projects and credible entrepreneur and to acknowledge the shariah factor. The significance role of religious consideration means that religious value will reduce agency problem. This finding consistent with Wilson (2002) who argue that there is a higher level of trust between Islamic banks and their client than that exist in conventional bank and hence the moral hazard risk are less. This is due to a greater degree of shared value, including ethical values related to honesty.

7. The Solution of PLS Financing's Problem: Knowledge-Based View

Instead of focusing on the negative behavior, KBV assumes that knowledge or capability is factor which determines firm performance. Henri (2006) argues that there are four capabilities which dominantly affect performance i.e. entrepreneurship, market orientation, organizational learning and product innovativeness. Whereas Mahama (2006) suggest that cooperation is external organizational capability which found to affect the performance in strategic supply relationship.

Concerning the performance of PLS financing, some writers argue that bank limited ability in conducting PLS financing may effect their performance (Lewis and Algoud 2001:131; Ahmed 2003; Iqbal & Mirakhor 2007: 113). To the extent that Islamic banks provide something akin to equity financing as compare to debt-based financing, they need to invest relatively more in managerial skills and expertise in overseeing different investment projects (Iqbal & Mirakhor 2007: 113). Lewis and Algoud (2001:131) argue that the lack of profit sharing financing practiced by Islamic bank because of limited number of Islamic banks' employees who have competence in Islamic bank activities. In addition, Ahmed (2003) asserts that the low performance of such kinds of financing is caused by lack of bank's ability in evaluationg and selecting both project proposal and entrepreneurs. Accordingly it is hypothesized that Islamic banks which have higher learning capability may have higher PLS financing performance compare to bank which lower organizational learning. Furthermore, Ahmed (2006:49) emphasized that more and more money should be allocated for research and training to acceletared the performance of Islamic bank.

Besides organizational learning, another firm capability which may rise PLS financing performance is product innovativeness. In financial institutions innovation represents the systematic process of change in instruments, institutions, and operating policies that determine the structure of our financial system. Innovations take the form of new securities and financial market, new products and services, new organizational forms, and new delivery system (Koch & MacDonald 2003: 20-21). Financial institutions change the characteristic of financial instruments traded by the public and create new financial markets, which provide liquidity. Bank managers change the composition of their banks' balance sheet s by altering the mix of product or service offered. For Islamic banks, innovation is necessarily to make Islamic financial product and services fiscally sound and competitive. Specifically, in Islamic bank innovation through product engeenering can be conducted by combining some contracts in shariah (Arbouna, M.B., 2003). Musharaka mutanaqisa financing may be viewd as an example of innovation in PLS financing product.

In service organization, it is important to recognize that buying services, customers tend not to be simply buying the elements of a service but something much greater and usually more intangible (Johnston & Clark). For example, in term of its elements, a hotel provides a bed, bathroom and food. However, in term of its concept which is selling to the customer, it can be provided anything from a low cost, comfortable night's sleep and unforgettable experience. Accordingly, in service organization, actually, what the customer wants is the concept offered by service organization. Furthemore, service organization which make different service, rare and immitable may have competitive advantage in the business (Gemmel 2003). The same case happens in Islamic Banking. To get competitive advantage in the banking industry, from the marketing concept, Islamic bank which focuses on the financing product similar to conventional bank may difficult in achieving competitive advantage. Accordingly, it is appropriate to reconsider what actually "the service concept" is to be offered to the customer. As frequently cited by many writers, the unique concept of Islamic bank compared to conventional bank is PLS contract. Consequently, to get competitive advantage Islamic bank should move their focus from debt-based financing to PLS financing. Concerning the firm capability argued by Henry (2006), in this case, Islamic bank which have higher market orientation may have PLS financing higher than their competitor.

Cooperation may influence the performance of PLS financing as Choudhury (1997) asserted that PLS financing reflected economic cooperation, therefore the capability banks conducting cooperation with the entepreneur may increase the performance of PLS financing. Lastly, entrepreneurship which generally consist of innovativeness and risk taking attitude also predicted to affect PLS performance. For example, Saiful Azhar Rosly (2005) asserted that the low practice of PLS financing may be due to risk-averse behavior on the side of Islamic bank, which in turn leads to a consequence of applying a more dominant debt-based financing which is less risky.

8. Discussion

From the aforemetioned explanation it implies that the dominant approach to examine factors influencing the performance of PLS financing is IBV based on agency theory. Previous studies using this perspective are conducted both conceptually and empirically. Generally, control mechanism identified to affect the performance of PLS financing can be categorized into two types of control i.e. external control mechanism and internal control mechanism. External control refers to control system focusing on the negative behavior of external parties from the perspective of Islamic bank, i.e. negative behavior committed by borrower. Specifically, external controls found to decrease negative behavior of the borrower are system monitoring and incentive-compatible constraint. Internal control refer to control system focusing on negative behavior of bank namely management control system.

Previous studies on financing of the banks suggest that control system significantly affects financing performance. Nevertheless, those studies mostly emphasizing the system to manage the behavior of the borrowers, including financial reporting standards issued by accounting profession (Beaulieu 1994; Lawrence et al 2002; and Kwok 2002), financing guideline issued by the bank that is 5C criteria of credit (Bester 1985; Besanko & Thakor 1987; Deakins 1994) and government regulation especially concerning capital requirement and maximum lending limit (Fabi et al. 2005). Even though some studies found that the behavior of banks' managers influence loan portfolio (Berger & DeYoung 1997; Willliam 2004), very limited studies addressed the role of control system to manage the behavior of banks managers especially the behavior of Islamic banks manager which is usually called as management control system.

Concerning PLS financing, empirical study mostly emphasizes the role of external control mechanism in reducing moral hazard of the borrower. The role of management control system in influencing negative behavior of the management of Islamic banks needs further investigation. Other writers also stressed the potential role of management control system in Islamic bank and argue that systematic research concerning the role of management control system or management accounting system in Islamic bank is relatively rare.

Further more, the finding of Hudayati & Auzair (2008) that there is a negative effect of attitude toward risk on the quality of profit sharing financing support the literature concerning the spillover effect of control system based on agency theory. Spillover effect, as Van der Stede (2000) analysed, means that the design of control system may provide a benefit to organization, however, at the same time there is a negative effect concerning the design of such kind of control on the other aspect. He found that there was a spillover effect concerning the use of rigid budgetary control style. The spillover effect he found is that the use of rigid budgetary control styles my decrease budget slack creation, however and the same time managerial short-term orientation increased.

Based on the argument that IBV may have spilover effect on the companies' performance, this paper suggests the use of KBV in the study of organization especially PLS financing performance. Nevertheles, no previous study examined empirically the role of control system in increasing PLS performance. Accordingly, further research to find empirical evidence on the suggested organizational capabilities, organizational learning, innovativeness, market orientation, entreprenership and cooperation, need to be conducted. Further more, future research may develop model empirically examining whether control system directly or indirectly affect PLS performance through organizational capabilities. Control system which potentially has important role in increasing PLS performance is also deserved further research. It includes external control system such as financial reporting, five C of credit, government regulation and internal control system known as management control system including performance measurement system, reward system and organizational structure.

9. Concluding Remark

Islamic banks deciding to apply PLS financing have direct interests in encouraging good managerial practices in the business of its customers. Accordingly, IBV approach in dealing with the performance of PLS financing may have the weaknesses should it were to apply in PLS financing. This is because IBV tends to focus too heavily on the use of collateral instead of the screening process (feasibility study). In addition, some writers argue that using IBV, the possibility of spillover effect may exist.

There are some adventages using IBV and KBV simultaneously in achieving PLS financing performance. Firstly, the roles of control systems are not only limited in reducing the negative behavior of Islamic bank or the customer but also in raising Islamic bank knowledge and capabilities. The focus of the study is not limited to examine the behavior of the customer which is mostly executed by previous study. Using KBV, organizational capabilities become important factor in dealing with Islamic bank performance especially PLS financing performance. Therefore, this perspective may have a consequence that the roles of management control system in Islamic bank become much more important for dealing with negative behavior of the manager of Islamic bank as well as to increase Islamic bank capabilities.

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