

CAN TRANSPARENT DISCLOSURE BE THE SOLUTION TO RESOLVE SHARI'AH AND ETHICAL ISSUES IN SPECIAL RESERVES OF ISLAMIC BANKS IN MALAYSIA?

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ABSTRACT

Islamic banks cannot promise to pay fixed rate of return to the depositors although they are trying to pay at least the same rate of return provided by the conventional banks. Changes in interest rate put additional pressure on the Islamic banks to compete with the conventional banks. One way to compete the rate provided by the conventional banks is to reserve some portion of profit to cover in the case of incurring losses from the investment. In Malaysia, Islamic banks are allowed to keep profit equalization reserve and investment rate reserve. However, there is no research has been done to examine any Shari'ah issues regarding these reserves. Therefore, this research focuses on these issues. The findings show that these issues are arisen due to using conventional rate of return as benchmark and deviation of the practice of these reserves from the original concepts of profit and loss sharing concept applied in the Islamic banks, negative impacts on zakat and income tax and no harmonization and standardization on the practices. It is believed that these issues can be solved and valid from the ethical and Shari'ah aspects investment account holders are well informed about these reserves and they agree on these practices. We expect that these issues should be revisited by the Shari'ah scholars, industrial players and regulators to ensure that all the involved parties are treated fairly.

Key Words: *Shari'ah, Ethical, Reserve, Islamic banks, Issues and Malaysia.*

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1.0 INTRODUCTION

Most of the Islamic banks are operating in the dual banking environment, where conventional banking has been dominating since the last few decades. Conventional banks are operating based on the concept of lending and borrowing and the rate of return is fixed. On the contrary, Islamic banks are not allowed to provide fixed rate of return to the investment account holders (IAHs) and the rate is based on the performance of the profitability of the investment. Islamic banks are operating based on the profit and loss sharing concept and it is difficult for the Islamic banks to offer the competitive rate of return when the investment is not profitable. Islamic banks are under pressure to offer the attractive rate of return to maintain competitive advantage and to mitigate withdrawal risk, displaced commercial risk and rate of return risk (Sundararajan, 2010). One of the mechanisms to maintain paying the competitive rate of return Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic financial services Board (IFSB) and Bank Negara Malaysia (BNM) have recommended the Islamic banks to allocate some portion of the yearly profit to profit equalization reserve (PER) and investment risk reserve (IRR).

Based on AAOIFI standard of accounting and auditing, FAS No. 9 (AAOIFI, 2008), PER is defined as “the amount appropriated by the Islamic bank out of the Mudharabah income, before allocating the mudarib share, in order to maintain a certain level of return on investment for investment account holders and increase owner’s equity.” It further defines IRR as “the amount appropriated by the Islamic bank out of the income of investment account holders, after allocating the mudarib share, in order to cater against future losses for investment account holders”. The purpose of allowing these reserves is to ensure that by utilizing them, Islamic banks are still able to pay the market rate of return to the depositors in the case of loss from the investment. This practice is allowed to protect the public interest and to serve the stability of banking system as a whole.

Malaysia which aims to be the hub of Islamic finance in the world, BNM concerns with the stability and competitive position of Islamic banks. Consequently, in 2001, BNM introduced a new mechanism in distributing profits for the Mudharabah deposit contracts. The practice of these two mechanisms has been sanctioned by Shari’ah experts in Malaysia. Since Islamic banking is the fast moving industry, all the relevant and necessary guidelines are not introduced yet and even for the existing guidelines, it might be important to amend or modify if there are

some issues to be rechecked and changes become essential. Many researchers have highlighted the existence of unfavorable Shari'ah and ethical issues in allocating these reserves. Thus, the objective of this paper is to highlight these issues and to provide the suggestions and recommendations to have fair and just Islamic banking.

This paper is organized in four sections. The second section highlights the Shari'ah and ethical issues. The third section provides the recommendation to resolve these issues and the last section concludes.

2.0 SHARI'AH AND ETHICAL ISSUES IN PER AND IRR

Muslims believe to practice *ijtihad* (independent reasoning) when any contemporary issues arise due to innovation of practice on adapting oneself into current situations. We must aware on Shari'ah compliance activities to avoid being manipulated or deviation from principles guided in Quran, *sunnah*, *ijma* (consensus), etc. The utilization of PER and IRR should not include elements of interest, uncertainty, speculation and other inputs that might contribute towards non-Shari'ah compliance verdict by the Islamic scholars.

2.1 Benchmark for rate of reserves

Due to operation of Islamic banking industry under umbrella conventional banking system, it forced Islamic banking institutions to compete with conventional banking institutions which have always full support of global and domestic monetary, regulatory in all aspects, compare to Islamic one. One of the challenges facing by the Islamic banks is to provide the competitive rate of return because market rate is based on the interest rate offered by the conventional banks (Zairy and Salina, 2010; Cevik&Charap, 2011).

In order to overcome this challenge, Islamic banks are allowed to keep some portion of the profit under PER and IRR and to use them in order to pay the market rate of return. From the depositors' aspect, the current depositors are required to forgo their deserved profit portion for the future in the case of loss (Hichem&Zied, 2013; Toumi & Viviani, 2013). If these current depositors do not continue depositing money, it might not be fair for the current depositors.

2.2 Decision to Hold Profit rather than Invest

It is a crucial discussion on creation of reserves since the Islamic bank will hold profit distribution rather than invest for future investment. The main reason is to mitigate risk of inability to provide sufficient return due to possibility investment losses will incur. We have to

be clear that PER play role when profit accumulation is high and low. When the profit pool is high, some amount will be transferred to PER. However, when profit pool is low, some amount will be used to support profit distribution to fund's depositors (Radziah, 2013). If depositor can have option either to utilise reserve or invest the holding profit in small risk investment, the depositors will surely choose to invest in small risk investment so that they can enjoy the proceeds.

2.3 Claim on profit by IAHs

One of main different of Islamic banks along with it is conventional counterpart is on the offer of unrestricted IAHs. Islamic bank share risks with shareholders due to structural relationship between shareholders of Islamic banks and unrestricted IAHs based on Mudharabah (partnership). Under this contract, one party as investor provides capital and the other party as Islamic bank in this situation provides labour. Profits are shared in pre-agreed ratio and loss, if any, is borne by the investor (Shari'ah standard 13, AAOIFI 2008). It is necessary for Islamic banks to know how to deal with different kinds of risks that are unique to them. Thus, Islamic banks create reserves such as PER and IRR to mitigate fluctuation of rate of return that is given to IAHs. By practicing that IAHs will not be affected by market rate and maintain it normal flow of return by means to smooth or to boost the rate.

According to framework set by BNM for exact amount that allowed allocating for Profit Equalization Reserve is up to a maximum 15% of total gross income every month. The exact Formula that is used for how much PER is following:

“PER (maximum monthly provision) = (15% x gross income) + net trading income + other income + irregular income such as recovery of non-performing financing (NPF) and write back of provisions” (BNM, 2003).

However, in Malaysia as per guideline of BNM, there is limit for Islamic banking institutions to maintain which a maximum is accumulated PER of 30% of Islamic banking Shareholder's Fund. In order to review aspect of accumulation and distribution of reserves both Profit Equalization Reserve and Investment Risk Reserve from Shari'ah and ethical Point of view, it requires excellent comprehension of Shari'ah law aspect of contract at first. The issue related to accumulation or distributions of profit equalization reserve is that although the reserves belong to the IAHs and shareholders of the Islamic banks jointly, the IAHs have no say or right to claim on

reserve in future (Andrew Cunningham: n.d.). For the short-term IAHs would be disadvantaged from this practice due to that some of today's active and robust profit are taken into reserve for future long run (after short term investor has left the fund), which will discourage always short-term investors to deposit in investment accounts.

2.4 Compliance with the Classical Contract of Mudarabah

From the Islamic perspective, the practice of PER in Mudarabah principle or mudarabah deposit contract seems not to be in line with the classical mudarabah contract. It is because none of the classical jurists had allowed such practice (Amir, 2010). As classical theory of mudaraba says that *rab-bul-mal* or capital provider has to bear complete risk and lose of capital while mudarib only lose his effort. Some also highlight that if a loss has been incurred in one period and profit is made in another period, the profit should be used to offset the loss until the entire loss has been written off and capital sum has been restored to its original level. The balance, if any, would be distributed between the parties in accordance with the agreed ratio. In this case, it seems that the profit is allowed to allocate for the distribution in the future and it allows only netting off the loss in order to restore the capital. Thus, it could be summed that current practices of PER and IRR seems not fully compliant with the classical contract of Mudarabah.

The critic on process of collection and distribution of profit in view of Shari'ah is due to permissibility concept. Normal practice of PER is doubtful since bank's management will not disclose the actual return achieved on investments. In addition, these reserves are distributed to the depositors by providing suitable return throughout the loss period. It is contradict to normal practice of mudharabah where the loss should be borne by depositors (*rab al mal*). In spite of this issue, Central Bank of Malaysia has issue guideline that PER amount can be used for other investment. The new investment should applicable in small risk portfolio as to avoid diminishing of current reserve value. Once income being generated from the new investment, the amount should be included in the PER account back.

2.5 Zakat and Income Tax Payment

Islam provides a mechanism for the redistribution of income and wealth via the institution of Zakat so that every Muslim is guaranteed a fair standard of living. The obligation of zakat on business activities was evident in the Quran and Sunnah. Allah declares "O you who believer! Spend of the good things which you have earned" (Al-Baqarah, 2: 267).

As Muslim investors, IAHs are required to pay zakat if the wealth meets the level of nisab. IAHs might be receiving lesser profit since some portion of the profit is allocated in PER and IRR (Mohamed, 2012) and hence, the zakatable amount might be lower than what they are supposed to pay. Consequently, it is not fair to the zakat recipients.

Similarly, Tax is defined as a compulsory payment imposed by government on individuals and corporate bodies. It is regarded as the civic right of the citizens and it is usually payable on certain percentage from income or profit as the case may be. The proceeds from tax are generally used by the government to provide infrastructural facilities and improve socio-economic status of the masses. Zakat and tax are ethical practices and should be paid before distribution of profits to investors and shareholders.

2.6 Harmonization or Standardization Issue

Small number of supervisory authorities has prescribed different ways in stabilizing rate of return. In some countries, either PER or IRR is allowed. In the case of Malaysia, using both types of reserves is allowed. Despite of this, some countries still not allowed utilization of PER or IRR. It depends on their jurisdiction. Therefore, no standardization on ruling on the PER and IRR calls for confusion among the industrial players and less confidence of the depositors on the Islamic banks. Thus, there should be a standard framework and it should be able to apply with flexibility.

The International Financial Service Board (IFSB) conducted a study on how PER and IRR are practised in a number of member countries in 2009, the results of the findings showed that profits and how they are appropriated to the shareholders as well as the IAHs usually remain undisclosed in annual reports. In any situations where they are disclosed, they do not declare the use of PER and/or IRR in their annual report. While some maintain just one reserve, either a PER or an IRR, some others made appropriations to the PER only out of the IAH share of profits after deducting the Mudaribshare which, according to the professional practice is a normal procedure for the IRR, but not for the PER. This is only beneficial to the shareholders as their profits available for dividends are not reduced by such appropriations.

Although, the practice of PER and IRR and some others have gone a long way to cushion the effect of future losses and insufficient funds in Islamic banking industry, this kind of uncertainty may engender, inconsistent and conflicting practices and conventions, thereby generating

confusion and eroding public confidence in the long-term soundness and stability of the industry (Greuning & Zamir, 2008).

2.7 Disclosure and Transparency Issue

There are issues arise in providing a true and fair view in accounting and financial reporting. This problem covers limited transparency related to the use, size and allocation of funds. According to IFSB report, limited disclosure about the account did not give comfort to depositors as bank may fail to manage the funds effectively. Later, the bank can be accused in doing abuse and manipulation as they have absolute power and control over the funds. Thus, it is important to disclose all transactions related to PER and IRR in accounting report (Ahmet, 2011; Greuning & Zamir, 2008).

3.0 RECOMMENDATIONS AND SUGGESTIONS TO RESOLVE THE ISSUES

Islamic religion has encouraged for good moral conduct for Muslim consumers as well as for Muslim producer in the economy, as for parties who are involved these reserves, it is always encourage to adopt ethical standard of Islamic religion that driven from Quran and Sun'nah and Athar (Good moral conduct of Prophet's Companions) and can be using for good teaching to corporate staff as well to customers, such as trustworthiness, There are a lot of versus in Quran and sunnah that promote good trusteeship such versus are following:

“Truly, we did offer Al-Amanah (the trust or moral responsibility or honesty and all the duties which Allah has ordained) to the heavens and the earth, and the mountains, but they declined to bear it and were afraid of it (i.e. afraid of Allah's Torment). But man bore it. Verily, he was unjust (to himself) and ignorant (of its results)” 4: verse 58 of Al-Nisa.

Also other verse in surah al-ahzab

“Verity! Allah commands that you should render back the trusts to those to whom they are due; and that when you judge between mean, you judge with justice. Verity, how excellent is the teaching which He (Allah) is Ever All-Hearer, All-Seer.” Chapter 33 verse 73 Al-Ahzab

These reserves should be invested in lesser risk and it seems to be permissible in Islam. A prominent Maliki jurist, al-Shatibi pointed out that istislah is proper ground for legislation. He quoted verse 21:107 from Holy Quran “We have not sent you but as a mercy for all creatures”. It is permissible to take advantage of flexibility and recognition of Shari'ah. In hadith, there are number of quotations can be used to support permissibility of reinvestment performance. For

example, “the Prophet (saw) only choose the easier of two alternatives so long as it did not amount to a sin”.

Fuqaha can use the method of *istishab* (Presumption of Continuity) where it is presumed the continuation of practice until it is proven wrong way to solve risk management issue. Shafie and Hambali School of Thoughts defined *istishab* as presume the continuation of both positive and negative until contrary is established by evidence. Accordingly, bank can operate PER under this principle until another appropriate way can be used to solve risk issue. Yet, this method is weak as compare to *ijma'* and *qiyas*. Although of its weak level of Islamic jurisprudence methodology, it is acceptable as long as the practice comply with Shari'ah principles.

There are lot of versus in Quran and sunnah that encourage for making easiness to Muslims and whenever, there are two or more options offered the one that more easy and simple are mostly promoted and encouraged in Shari'ah. It is highly recommended that if it going to encourage IAHs to remain and continue with Islamic banking investment pool instead of running away from Islamic banking due to fluctuation in rate of return of Islamic banks.

It is also important to remain and maintain contractual relationship between Islamic banks and IAHs which are based on partnership (*mudaraba*) which is based joint share profit which is not fixed but pre-agreed ratio. Therefore, it is very crucial to maintain this relationship instead the investors run away due to some fluctuations in rate of return. Since most important that money be used and invested in Shari'ah profitable way, there are a lot of evidences that encourage making profit in permissible way with unlimited profitability rate.

A good example is pertaining to the management of the orphan's property as prescribed by the Holy Qur'an:

“And do not give the weak-minded your property, which Allah has made a means of sustenance for you, but provide for them with it and clothe them and speak to them words of appropriate kindness.”

This verse explained the obligation to invest the properties of orphan children and to use the profits and not the capital or principal for their expenses. This is according to the opinion of *Imam Ar-Razi* who said that the word (فِيهَا) in the verse refers to the command to utilize some of the properties *asrizq* or goods. It means utilizing the properties to be *rizq* through trading

activities or by investing it in view of making profits, and the *rizq* distributed should be from the profits and not from the capital itself.”¹

Also there is no limited of percentage of making profit from Shari’ah. Therefore, it is encouraged to not fix the profit amount in general because there were some incidents where companions requested to fix price and prophet refuse to set the price, such event encourage Islamic banking institutions and investment account holders to go for profit oriented rather than conventional fix rate of return. Narrated by Anasibn Malik:

“(The people said: Apostle of Allah, prices has shot up, so fix prices for us. Thereupon the Apostle of Allah (PBUH) said: “Verily, Allah S.W.T. determinesthe climate of economic affluence and gloom. I do not want to take any action tofix the prices because I do not want, later in hereafter, any among you to demandfor the return of your property and blood from me because of my tyranny (infixing the prices).”

Therefore, it seems that using reserves as benchmark as minor issue, because more important issue in money deposited at IAHs to be utilized for benefit of Ummah (Muslim nation) and use for sufficient trade that might contribute to development of people in general at same time would benefit investors with unlimited profit or return on their investment.

Based on ethical aspect for issues of PER and IRR, the only way to resolve this controversial issue is to maintain good disclosure especially to actual rate of return on their investment funds, how many percentage of profit is allocated to these reserves and how these reserves are used. In addition, it should be stated clearly in the contract and it should be well informed to the IAHs (Andrew Cunningham: n.d.).

The practice is such that it promotes ambiguity between investors in particular and the public in general, and the IIFS competing for their funds. An attempt to conceal necessary information from the investors and all stakeholders will eventually lead to a false impression that an IIFS is performing better than it actually has performed. There are also issues of providing a true and fair view in accounting and financial reporting. This problem is further aggravated by the very limited transparency regarding the use, size and allocation of these funds. Limited disclosure does not necessarily provide comfort to investors regarding their fair treatment, as it may lead them to suspect the possibility of abuse and manipulation on the part of the IIFS since it has absolute control over their funds. If all important information is divulged, it is not out of place

¹Al-Razi, Fakhruddin Muhammad ibn Umar, *At-Tafsir Al-Kabir*, Dar al Ihya’ at-Turathi Al-Arabi: Beirut, v9 ,p186.

that some investors will be willing to forgo part of the profit pay-out in some years in order to have a reduced volatility of the expected level of pay-out (just as dividends to shareholders are normally less volatile than profits).

Islam places the highest emphasis on ethical values in all aspects of human life. In Islam, ethics governs all aspects of life. Ethical norms and moral codes discernable from the verses of the Holy Qur'an and the teachings of the Prophet are numerous, far reaching and comprehensive. Islamic teachings strongly stress the observance of ethical and moral code in human behaviour. Moral principles and codes of ethics are repeatedly stressed throughout the Holy Qur'an. Besides, there are numerous teachings of the Prophet which cover the area of moral and ethical values and principles. Says the Holy Qur'an:

You are the best nation that has been raised up for mankind; you enjoin right conduct, forbid evil and believe in Allah. (3:110)

The Prophet (saw) is also reported to have said: I have been sent for the purpose of perfecting good morals. (IbnHambal No: 8595).

The above quotations emphasize the need to uphold sound moral quality standard in all our affairs be it mundane or celestial.

Furthermore, Islam encourages truthfulness in business transactions and raises the status of a truthful merchant to the level of the martyrs, in the Hereafter. The Prophet said: The truthful merchant [is rewarded by being ranked] on the Day of Resurrection with prophets, veracious souls, martyrs and pious people. (Tirmidhi, No: 1130).

The Prophet (saw) has also exhorted the believers to strictly adhere to truthfulness in business transactions. He says: The seller and the buyer have the right to keep or return the goods as long as they have not parted or till they part; and if both the parties spoke the truth and described the defects and qualities [of the goods], then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost (Bukhari, No: 1937).

The tradition implies that Allah blesses business dealings if both the buyer and the seller are truthful to each other. Telling lies and hiding facts will result in the loss of divine blessing. A tradition reads.

The Holy Prophet said: 'Traders are wicked people'. The Companions asked: 'O Messenger has Allah not permitted business?' The Messenger replied: 'Of course He has declared trading lawful. But they (i.e. the traders) will swear by Allah and do evil; they will not speak but tell lies'. (Ahmad, No: 14982). Here, the prophet encourages us to be transparent and not to conceal any defects in the object of transaction. A cursory look at the practice of PER and IRR involves some manipulations and refusal to give true and fair view of the state of the investment on the part of managers. This makes such practice unacceptable, null and void according to Shari'ah.

Moreover, trustworthiness is one of the most important principles of ethical discipline in commercial transactions. Trust is a moral virtue and duty incumbent on a Muslim in the performance of his affairs. It demands sincerity in work and purity of intention from every believer. A true Muslim trader will not, therefore, barter his *Akhirah* (hereafter) for worldly gains. He will avoid fraud, deception, and other dubious means in selling his merchandise. The sense of mutual trust demands that the pros and cons of commodity be revealed to the buyer so that he purchases the commodity in full satisfaction. Says the Holy Qur'an: O you believers! Do not betray Allah and the Messenger, nor knowingly, betray your trusts. (8:27)

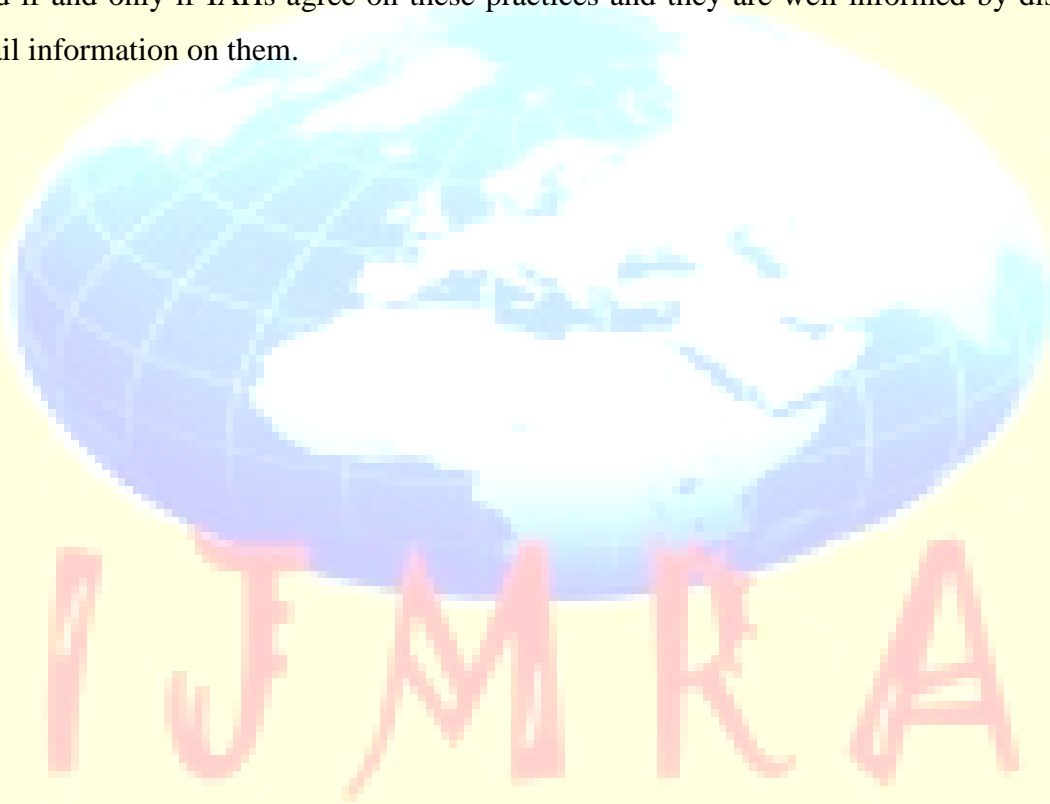
Islam attaches great importance to the fulfilment of contract and promises. Islamic teachings require a Muslim trader to keep up his trusts, promises and contracts. The basic principles of truth, honesty, integrity and trust are involved in all business dealings. The Holy Qur'an emphasizes the moral obligation to fulfil one's contracts and undertakings. A verse states thus: O you who believe! Fulfil [your] obligations. (5:1)

A tradition of the Prophet states thus: The Muslims are bound by their stipulations. (*Abu Da'ud*, No: 3120). In another tradition, promise-breaking is condemned and seen as the hallmark or trait of a hypocrite: If he makes a promise, he breaks it, and if he makes a compact, he acts treacherously. (*Bukhari*, No: 32)

From the foregoing, it is crystal clear the prophet forbids business men to betray or deceive and equate such endeavour as hypocritical. The practice of PER and IRR in the industry has to be checkmated to avoid committing business hypocrisy and deceit which has been seen to be unethical and anti-Islam.

4.0 CONCLUSION

This paper intends to highlight the Shari'ah and ethical issues in PER and IRR practiced by the Islamic banks. Malaysia is chosen as a focus in this study since it is one of the leading countries in the Islamic finance. The purpose of these reserves is to protect the Islamic banks from losing depositors if they cannot provide the market rate of return like conventional banks. These reserves are allowed but after implementation, many Shari'ah and ethical issues have been raised. The source of this problem is benchmarking conventional rate as market rate of return. Consequently, it leads to other Shari'ah and ethical issues. It is believed that these issues can be resolved if and only if IAHS agree on these practices and they are well informed by disclosing the detail information on them.



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