

Musharakah Financing: Experience of Pakistani Banks

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Abstract: Although Musharakah and Mudarabah are the two main authentic Islamic modes of finance in Islamic banking system but the Islamic banking industry is at-least partially failed to promote these basic Islamic modes of finance. Instead Murabaha and Ijara play a major role now-a-days in Islamic banking businesses. The present study tries to find out the causes compelling Islamic banks to restrict the growth of Musharakah financing to a minimum level. Opinion survey of Islamic bankers, professors, and economists is conducted through questionnaire. Findings suggest that there are various reasons for the slow growth of Musharakah financing in Pakistan. Lack of interest of the bank management in Musharakah financing, lack of committed, honest and skillful entrepreneurs, lack of expertise, lack of government support are some of the main causes of slow growth of Musharakah as a mode of finance.

Key words: Islamic Banking · Modes of Finance · Musharakah

INTRODUCTION

Pakistan came into existence in 1947, the then largest Muslim country, on the map of the globe on the basis of ideology of Islam. Being an Islamic ideological and a Muslim majority state, Pakistan was morally, legally, historically and ideologically bound to have its socio-political, economic and banking system based on Islam—the complete code of life. That is why, Mr. Zahid Hussain, the then Governor of the State Bank of Pakistan (SBP) made the following observation on the occasion of the inaugural ceremony of the SBP in July 1948 at Karachi:

“Banking practices must be subjected to careful scrutiny on scientific lines by competent economists well acquainted with the basic principles and requirements of Islam. Their object must be to find out in what manner and on what lines it would be practicable to harmonize banking practices with the requirements of Islamic ideals of social and economic life.

It is our intention that the research organization which we propose to establish in the State Bank should devote special and unremitting attention to this most important aspect of our ideological problems.” [1].

This opening ceremony of the SBP was presided by Muhammad Ali Jinnah, the founder of this country. He endorsed in his presidential speech the talk of Mr. Zahid Hussain, the Governor of the SBP and clearly expressed himself about the failure of the West in these words:

“The economic system of the west has created almost insoluble problems for humanity.....It has failed to do justice between man and man and eradicate friction from the international field. On the contrary, it was largely responsible for two world wars. The Western World in spite of its advantages of mechanization and industrial efficiency, is in worse mess than ever before in the history. The adoption of Western economic theory and practices will not help us in achieving our goal of creating a happy and contented people.” [2].

Quaid-e-Azam Muhammad Ali Jinnah stressed upon the SBP to devise and adapt banking practices that would be compatible with the Shariah of Islam and serve the welfare of not only the Muslims but humanity at large.

It was also constitutionally mandatory for the rulers of Pakistan to implement Islamic banking system. Chapter 2 of part II of the unanimously adopted 1973

Table 1: Progress of the Islamic Banking Industry in Pakistan- 2003-2011 (Rs. in Billion)

	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11
Total Assets	13	44	72	119	206	276	366	477	641
Share in Industry (%)	0.5	1.5	2	2.8	4	4.9	5.6	6.7	7.8
Deposits	8	30	50	84	147	202	283	390	521
Share in Industry (%)	0.4	1.3	1.8	2.6	3.8	4.8	5.9	7.2	8.4
Financing & Investments	10	30	48	73	138	186	226	338	475
Share in Industry (%)	0.5	1.3	1.7	2.3	3.5	4.3	4.5	6.2	7.4

Sources: SBP (Sep, 2009, Vol. IV (3) and Dec 2011, vol. 6 (3), Islamic Banking Bulletins, Islamic Banking Department.

constitution deals with the Principals of Policy. Clause 'f' of article 38 of the constitution clearly and unambiguously states that the state shall eliminate Riba (interest/sood) from the economy as early as possible. Concrete effort was made by General Muhammad Zia-ul-Haq, the then president of Pakistan. While delivering his speech to the national assembly at Islamabad in February 1st, 1979 declared that within three years period of time, interest-free banking system would be prepared and implemented in Pakistan and therefore, according to the recommendations of the 'Superior Task Force' constituted by the SBP, 7,000 branches of the nationalized commercial banks started, for the first time in the history of Pakistan, accepting deposits on the basis of profit and loss sharing (PLS) system from January 1st, 1981. [3] It basically laid the foundation for a paradigm shift towards a banking system based on the principles of Shariah of Islam.

General Muhammad zia-ul-Haq might be intended to eliminate interest completely from the banking system but it did not happen during his tenure of government. The successive governments after Zia-ul-Haq tried to postpone the Islamization of the banking system and elimination of interest for one reason or the other. Islamization of banking sector was possible only when the rulers were serious and determined to implement the verdict [4] of the Federal Shariah Court.

It was in the late 1990s and early 2000 that the SBP framed rules and regulations and issued licenses for setting up full-fledge Islamic banks especially in the private sector which created Islamic banking industry (IBI) in the country. During this period, on the one hand, SBP struggled hard for developing a sound regulatory framework based on the principles and recommendations of the Accounting, Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Financial Markets (IIFM); and on the other hand, SBP also strived to devise a Shariah compliant system acceptable to all the stakeholders of the banking sector [5]. As a result of the SBP initiative and struggle, the people of Pakistan see that Islamic banking sector has been experiencing tremendous growth in Pakistan since

2000. Table 1 below shows some important data about Islamic banking industry in Pakistan. It shows that the total assets of Islamic banking tremendously increased to Rs. 641 billions in December 2011 as compared with only Rs. 13 billions in December 2003, shows a remarkable achievement by the Islamic banking sector. The same table simultaneously shows the share of Islamic banking in the total banking industry which reaches to 7.8 percent in December 2011 compared with just 0.5 percent in December 2003.

The financing and investments made by the Islamic banks in Pakistan increases to Rs. 475 billions from Rs. 10 billion in December 2003. On the deposits side, the total deposits of the Islamic banks were only Rs. 8 billion in December 2003. Rs. 22 billion were added during 2003-04, Rs. 34 billion in 2005-06, Rs. 63 billion during 2006-07, ultimately reaches to Rs. 521 billion in Dec 2011. While the percentage share of the Islamic banking industry rose to 8.4 percent in Dec 2011 from only 0.4 percent in December 2003. Over all, Table 1 depicts spectacular progress of the Islamic banking industry.

Definition of Musharakah: Literally the word Musharakah means sharing or mingling. In Arabic language, the root words of Musharakah are shirkah or shirk which means partnership. So, Musharakah refers to the act or contract of making a partnership between two or more parties. It is a participatory mode of finance which basically involves direct participation of the parties in profits as well as losses, if any [6]. Assigning partners to Allah is also referred to as shirk [7]. The term 'Musharakah' can be defined as a joint enterprise formed for conducting some business in which all partners (two or more) share the profit according to a specific agreed ratio while loss is shared according to the ratio of their contributions [8]. In banking sector, it is a mode of financing based on the principle of profit and loss sharing in which parties to the contract participate with their money or effort, or skills or a contribution of them as may be provided for in the Musharakah investment agreement contract by the mutual consent of

Table 2: Gross Financing and Musharakah Financing of the Islamic Banking Industry in Pakistan (Rs. in billion)

Year	Total Gross Financing	Financing in Musharakah	Musharaka Financing (%)
Dec-2006	65.7	0.533	0.8
Dec-2007	108.2	1.68	1.55
Dec-2008	146	2.64	1.70
Dec-2009	158.6	2.8	1.80
Dec-2010	190.2	5.5	2.90
Dec-2011	211.8	5.1	2.40

Sources: SBP (Sep, 2009, Vol. IV (3) and Dec 2011, Vol. 6 (3), Islamic Banking Bulletins, Islamic Banking Department.

the parties. All parties to the contract shares profit as well as loss. The profit (if any) is divided among the partners according to the agreed ratio, while loss (if any) is distributed exactly according to their ratio of investment in the business.

Types of Musharakah: There are two broad categories of Shirkah or partnership in Islamic jurisprudence. They are Shirkat-al-Milk and Shirkat-al-Aqd. Let us have a look at them.

Shirkat-al-Milk: Shirkat-al-Milk is also known as proprietary partnership or partnership by ownership. It is further divided into two kinds:

Optional Partnership (Ikhtiyari): It is obvious from the very name of this kind of partnership. The relationship among the partners or parties comes into existence at their own well and option.

Compulsory Partnership: (Ghair Ikhtiyari): It is also known as non-optional partnership. Under this kind of partnership two or more than two persons becomes partners with out their own effort or consent. The simplest example is the property of the deceased becomes a joint ownership of his/her heirs.

Shirkat-al-Aqd: Shirkat-al-Aqd is also known as contractual partnership or partnership by contract or joint commercial enterprise. It is an agreement between two or more individuals to share their assets, labor or liabilities for the purpose of earning profit [9]. This type of partnership is affected by the mutual contract among the partners. It is further divided into three major types.

Shirkat-al-Amwal: The Arabic word Amwal means money or capital. This is a partnership in capital or investment when all members of the contract invest some capital into a business or commercial enterprise.

Shirkat-al-Aamaal: The Arabic word Aamaal is the plural of Amal which means action, deed, labor or service. Shirkat-al-Aamaal is also referred to as Shirkat-al-Sanai (because the capital of the partners is their skill) or Shirkat-al-Abdan (because the partners perform certain manual labor like tailors, electricians, butchers etc). This is a partnership in services where all members or partners jointly undertake to render some services for their customers and the income earned is distributed among them according to an agreed ratio.

Shirkat-al-Wujuh: It is known as credit partnership. The word 'Wujuh' is Arabic word which means face, which can be further used for reputation and goodwill. So, the partners in this type of partnership do business using their reputation and goodwill in the market instead of their skill and capital. The people trust in them due to their sense of responsibility and trustworthiness and their entrepreneurship qualities. They buy goods and commodities on credit or deferred price and sell them at spot for cash. The profit so earned is then distributed at an agreed ratio among them.

Relationship of Musharakah with Total Financing in Pakistan: If we look at the percentage of Musharakah financing of the Islamic banking industry, it is not very encouraging. Although it is increasing with every passing year but the increase is negligible. Table 2 shows that in 2006 the total financing of the Islamic banking industry stood at Rs. 65.7 billion, however, Musharakah financing out of this total was only Rs. 0.533 billion which constitute only 0.8 percent of the total gross financing of the Islamic banking sector in Pakistan.

In 2007 the total financing stood at Rs. 108.2 billion while Musharakah financing out of this total was Rs. 1.68 billion which is quite encouraging as compared to the previous year figures. But it was just 1.55 percent of the total financing of the Islamic banking industry. This increasing trend in the Musharakah financing continues till December 2010 which stood at 2.90 percent

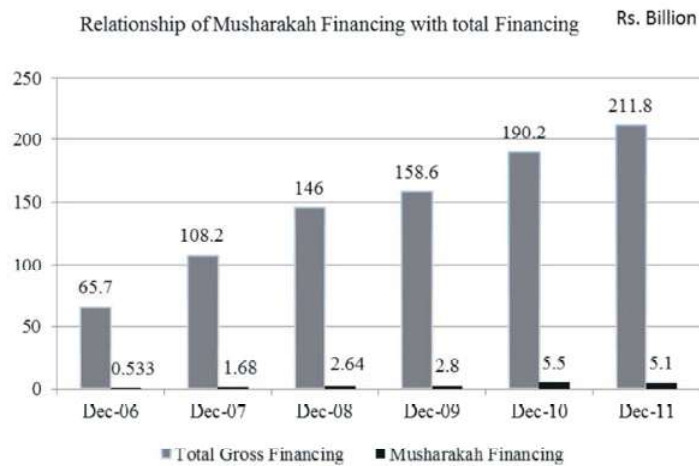


Fig. 1: Relationship between Musharakah Financing and gross Financing of the Islamic Banking Industry in Pakistan

then it declined again to 2.40 percent in the year 2011. The relationship of Musharakah financing with the total gross financing of the Islamic banking industry in Pakistan is best explained in the Figure 1 below.

The figure shows that total financing of the banking industry increases very rapidly since 2006 onward. The total volume of gross financing was Rs. 65.7 billion in 2006 which increased to Rs. 211.8 billion in 2011. However, the Musharakah financing has increased to Rs. 5.1 billion in 2011 from as low as Rs. 0.533 billion in 2006. Although Musharakah financing has increased percentage wise since 2006 from 0.8 percent to 2.4 percent in 2011, but it is not so encouraging as compared to Murabaha, Ijarah and Diminishing Musharakah. The percentage share of Murabaha, DM and Ijara are 43.8 percent, 32 percent and 10.4 percent of the total financing respectively in December 2011 [10].

From the available literature on Islamic banking and their modes of financing, profit and loss sharing modes, (i.e. Mudarabah and Musharakah) have been considered the most authentic modes of finance. It has also been proved theoretically and empirically as well that these modes of financing are inherently more stable which helps in preventing any prolonged business fluctuations [11]. However, Islamic banking industry failed in adopting Musharakah and mudarabah modes of finance in their business activities [12]. Maulana Muhammad Taqi Usmani, a leading Shariah Scholar also comments on the share of Musharakah financing and says that Islamic banking should have advanced towards Musharakah in gradual phases and should have increased the size of this mode of finance [13]. Figure 1 is also depicting the true

and the same picture of Musharakah financing share of the total financing of Islamic banking industry. The present study tried to find out the causes of slow growth of Musharakah as a mode of finance in Pakistan through a survey conducted in the province of Khyber Pakhtunkhwa.

Data and Methodology: The prime aim of this study was to ascertain the causes and hurdles in the growth of Musharakah financing in Pakistan. For this purpose a survey was prepared and distributed among those people (respondents) who are presently working in Islamic banking industry in position grade II or above and those who teach Islamic banking and Islamic finance as subjects in the universities of this province, Khyber Pakhtunkhwa. The data and information so collected were converted into averages and percentages and the results were obtained. Other related data were obtained from the published annual and quarterly reports of the Islamic banking division, State Bank of Pakistan, Islamabad.

Causes of Low Growth of Musharakh as a Mode of Finance: The percentage of Musharakah financing out of total Islamic financing mix is only 2.40, while Musharakah and Mudarabah are the two main and uncontroversial, according to Sharaiah scholars, modes of finance. There can be so many reasons. This study is designed to make an effort to know the basic hurdles and problems in the way of growth of Musharakah as a mode of finance. For the purpose, a questionnaire was prepared for taking opinions of the banking professionals, professors who teach Islamic banking and finance in the universities of

Khyber Pakhtunkhwa, and other related people. Some important hurdles/questions were asked in the survey. Here it would be beneficial to discuss each of these hurdles which were included in the survey.

Unavailability of Guidelines/Regulations from the Central Bank: One of the hurdles in the way of popularity of Musharakah financing in Pakistan may be the unavailability of guidelines and regulations from the State Bank of Pakistan. Interest-free banking industry has been introduced recently in 2002; therefore, it is in its infancy period now. State Bank of Pakistan has already setup a division called Islamic Banking Division (IDB) to make and provide guidelines and regulations to the fast growing Islamic banking industry. Since Islamic banking industry is a newly emerging financial industry therefore, complete guidelines and regulations for banking products will take time.

Lack of Interest of the Bank Management: The second hurdle in the adoption of Musharakah mode of finance included in the questionnaire is the lack of interest of the management of the Islamic banks. Various reasons can be cited. For example, one reason may be the ignorance of the banking staff about the Shariah rules, conditions, validation, cancellation, and termination of Musharakah, because most of the banking staff members have been either hired from conventional banks or they are fresh graduates having no knowledge of shariah of Islam and Islamic banking and practices.

Unavailability of Legal/Government Support: Unavailability of government support to Islamic banking industry may be another cause of unpopularity of Musharakah as a mode of finance. We have a dual banking system in Pakistan—interest-free banking and interest-based banking system. The later has the support of successive governments since the birth of this country in 1947 and legal cover and protection has been provided to it. While on the other hand, interest-free banking system which has been introduced only a decade before in the private sector, therefore, it is in its infancy stage faces a lot of legal and moral hurdles in its achievements and successes.

Lack of Expertise: The popularity of Musharakah as a mode of finance may also depend on the experience, expertise, and training of both the staff of the bank and its customers. The products of Islamic banking are new as compared to conventional banking products, therefore,

both staff of the Islamic banks and customers are not familiar with these modes of finance and hence no expertise. Moreover, the banking personnel as mentioned have no knowledge of Islamic banking products and Shariah principles and on the other hand, customers who seek Islamic modes of finance for their projects also have no related experience. Obviously it will impact the growth of Musharakah.

Risk of Loss: Another problem and hurdle in the way of success Musharakah as a mode of finance may be the risk of loss. Musharakah means two or more partners conducting a business jointly. All the partners share the profit according to an agreed ratio while loss (if any) is also shared according to the ratio of their contribution to the business. So, the future is uncertain, the business may earn profit or incur losses. Musharakah, therefore, is more risky as compared to other Shariah compliant modes of finance and the demand for Musharakah remains low.

Accounting Problems: Accounting problems may also work as a hurdle in the growth of Musharakah in Pakistan. Islamic banking industry follow the old conventional accounting methods which are not in consonance with the spirit and requirements of the products of Islamic banking, therefore, these conventional accounting methods and techniques might create problems for the growth of Musharakah.

Lack of Committed, Honest, and Skillful Entrepreneurs: Lack of committed, honest and skillful entrepreneurs may be another hurdle. Islamic banking system as well as Islamic economic system is primarily depends on the moral system of Islam and then on its legal system. Islam gives importance to morality in order to maintain uniformity of conduct, peace, tranquility and brotherhood. If, by any means, moral fabric of the society becomes weak, strong legal system becomes operational to compel the wrongdoers within the limits. In today's Pakistan honesty, truth, and commitment to one's job is almost non-existent. Moreover, the entrepreneurs have also no requisite skills. This situation prevails at all levels in our financial institutions.

Lack of Interest from Customers: Clients of the banks also do not want to become partners of the banks in Musharakah. There are other less risky and less laborious modes of finance available, therefore, they may not prefer Musharakah contract.

Customers Disagree to Share High Profit Ventures:

Some time customer does not want to share real profit of his venture which is higher than the kibor rate with the bank and he select fixed return product of Islamic banks i.e., Murabaha, Ijara or Diminishing Musharaka rather than Musharaka or Mudaraba. Because in Musharaka he will have to share his actual profit with the bank

Unavailability of Checks and Balances Mechanism of Musharakah Business: Another hurdle in the way of growth of Musharakah may be the non-availability of checks and balances mechanism of Musharakah business. Since Musharakah and Mudarabah modes of financing are still a negligible part of the total financing mix of the Islamic banking industry, the mechanism of checks and balances for these modes is almost non-existent. However, with the growth of these banking products, it is now felt that a viable mechanism of checks and balances is to be adopted.

Taxation Issues: One of the important canons of taxation is ability to pay. The policy of the government should be based on the affordability of the burden of taxes. If the taxes are high, the business community will not declare the exact amount of profit in order to avoid payment of taxes.

RESULTS AND DISCUSSIONS

Musharakah mode of finance is generally considered as the most authentic and main mode of Islamic banking system by the Shariah scholars. However, it may not be easily and dominantly practiced especially in the prevailing socio-political and economic environment of Pakistan. The present study tried to ascertain the main causes and hurdles in Musharakah as a mode of finance through a questionnaire and a survey. The questionnaire was distributed among those people who are in one way or the other related to Islamic banking business. The results have been summarized and presented in Figure 2.

The pie-graphic representation of the results indicates the opinions of the respondents in percentage form. Total twelve questions have been asked in the questionnaire. One of the questions asked in the questionnaire was whether taxation issues restrict the growth of Musharakah mode of finance? There is a legal discrimination between profit and interest (sood) regarding taxation. The amount of profit (if any) earned in a business is taxed while interest is exempted from taxation. This unfair treatment and discrimination between interest and profit is considered to be a major obstacle and makes Musharakah or PLS modes of finance less

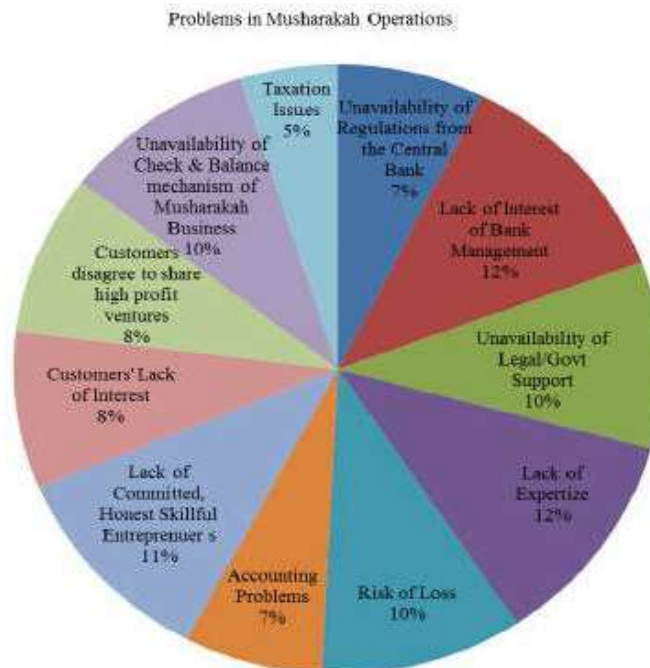


Fig. 2: Causes of slow growth of Musharakah Financing in Pakistan.

reliable modes [14]. Moreover, if the burden of taxes is high, the business community will undoubtedly not declare the true picture of their profit in order to avoid the payment of taxes to the government. According to the results of the survey, taxation issues work as a hurdle, however, its impact is as low as 5 percent.

The questions that have been given high weight by the respondents through percentage were the lack of interest of the bank management in promoting Musharakah as a mode of finance and lack of expertise on both the sides—the management of the bank and the customers. The management of the bank does not take interest in promoting this mode of finance due to various reasons. For instance, majority of the present staff of the Islamic banking industry either has been hired from the conventional banks or they are fresh graduates having no knowledge of Islamic banking and finance. Secondly, PLS modes of financing requires additional monitoring staff and mechanisms which increase the costs of these modes of finance, therefore, they do not want to get involved in these types of projects [15]. Third, according to them, Mudarabah and Musharakah modes of financing also require a lot of information about the abilities and capabilities of the entrepreneurs which may not be so easily and readily available. According to the respondents, both these factors (lack of expertise and lack of interest of the bank management) retard the growth of Musharakah financing 12 percent. Lack of commitment, honesty and lack of entrepreneurial skills of the customers also retards the positive trend in Musharakah business through Islamic banks in Pakistan as shown in Figure 2. Equally important is the support of the government and judicial system of the country. Islamic banks are working in isolation and mostly with out the support of their respective governments [16]. There is a dual banking system in Pakistan—interest-based and interest-free Islamic banking system. Interest-based banking system has the support of the successive governments since the inception of Pakistan in 1947 and legal cover and protection has provided to it. While on the other hand interest-free Islamic banking system has been introduced recently in 2002 in the private sector only. Therefore, it is in its infancy stage now and secondly it faces a lot of legal and moral hurdles in its achievements and success.

Risk of loss and the unavailability of checks and balances mechanism is another reason and cause of slow growth in Musharakah as a mode of finance. Its role is 10 percent according to the opinion of the respondents. Customers' lack of interest in Musharakah business also

impacts adversely the growth of Musharakah. There are other less risky and less arduous modes of finance are available in the financial market, therefore, they are less inclined towards more risky Musharakah mode. Moreover, they also do not want to share their high profit with banking management which ultimately hampers the growth of Musharakah financing. Both plays 8 percent role each. Another hurdle is that there is some accounting problems associated with this mode of finance. Islamic banking uses the conventional banking accounting procedures and techniques which are basically not in consonance with the spirit and requirements of the Islamic banking practices. Moreover, it may be the complexity of the accounting issues which keeps the growth rate of Musharakah financing low. Equally important is the unavailability of guidelines and regulations from the State bank of Pakistan (SBP). Both plays 7 percent role each.

Hundred percent of the respondents were unanimous that they are not satisfied with the prevailing position of Musharakah as a mode of finance in relation to the total/gross Islamic financing of the Islamic banking industry in Pakistan.

CONCLUSION

The real Islamic banking mainly consists of Musharakah and Mudarabah modes of finance and these two modes of financing do not grow at a rate equivalent to the growth rate of Murabaha and Ijara due various reasons. Some of the causes of the slow growth of Musharakah financing include lack of interest of the bank management itself, lack of committed, honest and skillful entrepreneurs, lack of expertise, no government support, unavailability of checks and balance system and some complex accounting issues related to Musharakah mode of finance.

To promote Islamic banking, universities and other research organizations and institutes should start academic programs and research in the area of Islamic banking, Takaful and Islamic Finance in order to equip and train the youth and provide the required human resource to Islamic banking and finance industry. This will also help in educating the masses at large.

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Appendix-A

Survey about Musharaka Financing in the Islamic Banking Industry of Pakistan

Name (Optional): _____

Position (Optional): _____

Qualification: _____

No of Years Served in Banking Industry: _____

1. Are you satisfied with the present position of Musharaka in total Islamic Financing?
Yes[] No[]
2. Kindly indicate in percentage the causes/hurdles which compel Islamic Banks to restrict the growth of Musharaka to a minimum level.
 - a. Un-availability of guidelines/regulations from the Central Bank: _____
 - b. Lack of interest of Bank Management: _____
 - c. Un availability of legal/Govt support: _____
 - d. Lack of Expertise: _____
 - e. Risk of loss: _____
 - f. Accounting problems: _____
 - g. Lack of Committed, honest skillful entrepreneur: _____
 - h. Lack of interest from Customers: _____
 - i. Customers disagrees to share high profit ventures: _____
 - j. Un-availability of check and balance mechanism of Musharaka Business: _____
 - k. Taxation Issues: _____

Any other:

- (1) _____
- (2) _____
- (3) _____
- (4) _____
- (5) _____

3. Kindly mention what steps may be taken for further promotion of Musharakah?

- 1. _____

- 2. _____

- 3. _____

Thank you for filling this questionnaire.