

The Rational Behavior Concept in Islam and Policy Framework Perspectives

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Abstract: The primary notion of preference and utility under Islamic perspective is to restore the consumer behavior in accordance with the concept of *maslahah*. The paper basically tries to apply the concept of *maslahah* by specifically defining it into Good Deeds (G) and Bad Deeds (B) concepts subject to a certain limit of Ability (A). Hicksian and Marshallian demand functions are used to model *maslahah* under Islamic banking practices in Indonesia and Malaysia. The paper employs several variables to gauge the *Maslahah* (M) as well as Ability (A) function. Empirically, the variables used to measure *Maslahah* function are deposit, financing, and rate of return variables. In addition, Cobb-Douglas (CD) utility function is utilized to model the *maslahah*. Indonesia seems to have bigger *maslahah* compared with Malaysia according to Islamic Banking practices, but more effort should be persistently undertaken by Indonesian Islamic Banks to retain a certain level of *maslahah* instead of Malaysia. Since *maslahah* is seen as the manifestation of Good Effort (Eg), some policies frameworks could be suggested, namely regarding *shariah* framework, tax regime, and some outstanding issues and challenges for Islamic banking development.

Keywords: Maslahah, Islamic banking, Indonesia, Malaysia

Introduction

According to Oxford Dictionary, rationality is defined as means based on or in accordance with reason or logic, able to think sensibly or logically and having the capacity to reason. In the context of economics, according to Marc Le Menestrel (2001), between economic rationality and ethical behavior are in opposite direction. There are likely to be venality and sacrifice.

According to table 1, such behavior undertaken under conventional perspective agrees that the above behaviors embody an irreducible tension between ethical concerns and economic

interest, which then lead to economic rationality. In other words, an ethical dilemma occurs when one has to choose a behavior where economic interest and ethical concerns conflict.

Table 1: Unreasonable Reductions

No	Possible Reduction	Equivalent Statement
1	Profit is necessarily ethical	Unethical behavior never pays
2	Ethics is necessarily	Profit is always unethical
3	Unethical behavior is necessarily profitable	Costly behavior is always ethical
4	Ethics is necessarily profitable	Costly behavior is always unethical

However, unlike mainstream economics, the Islamic economics places the rationality based on Islamic worldview. This worldview fundamentally puts the *Tawhidic Paradigm* as the source of belief and rationality. In details, the Islamic concept of rationality was deliberated by Khursid Ahmad (1992:7) "Does not deny either the internal consistency of axioms and postulates or self-interest as one of the main determinants of human behavior but it puts a restrain on self-interest by linking it with individual and social responsibility and morality in general". The obvious difference of rationality between two distinct perspectives could be summarized as shown as below:

Table 2: The Element of Rationality under Islamic and Conventional Perspectives

Rationality Elements	Conventional	Islamic
Worldview	Secular, keeping away any religious and moral values	Belief in the Day of Reckoning
Self-Interest	Maximize self-interest without limit	Recognize self-interest and limit it according to shariah compliance

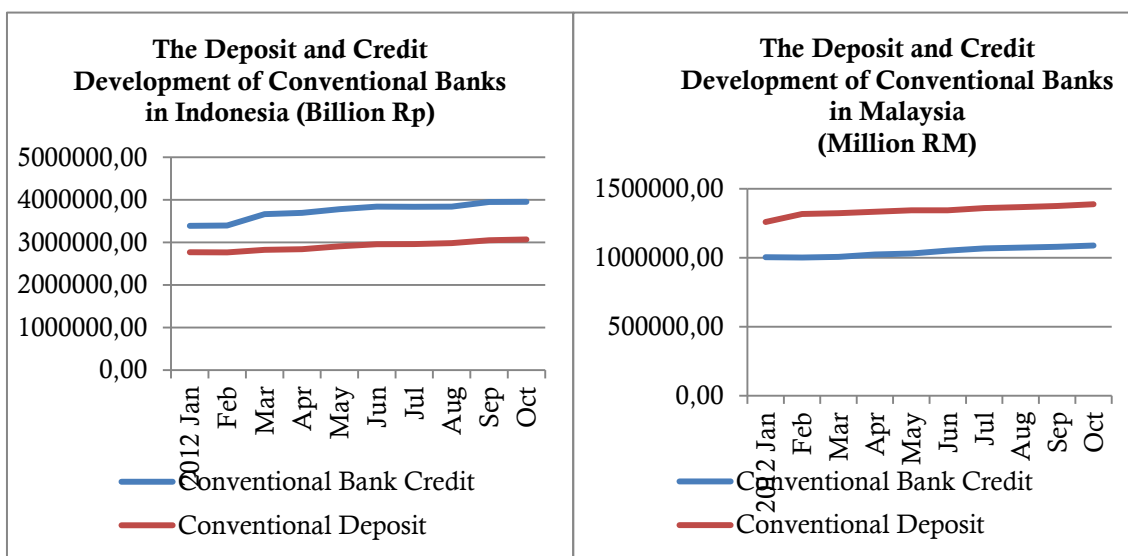
Source: Asharaf Mohd Ramli and Mirza (2007)

The concept of rationality in Islamic perspective later extends its scope towards the attainment of *maslahah* concept. Literally, the word *maslahah* is defined by al-Shatibi (d.790) as "all concerns that promote the subsistence of human life, the completion of man's livelihood and the acquisition of all his physical and intellectual qualities for him" (al-Shatibi, 1990, p.15). In essence, *maslahah* concept has objectives for preserving the well-being of the society by interpreting the shariah, including the pursuit of the objectives of the shari'ah (*maqasid al-shariah*), namely educating individual, establishing justice, and promote welfare.

In the context of current practices, the application of *maslahah* can be traced out through the Islamic banking practices, which is shown by the development in the financing and deposit sides. Malaysia and Indonesia could be very interesting to be further elaborated due to theirs practices which are persistently growing in terms of assets over the last twenty years. According to Bank Indonesia Report per October 2012, Islamic banks have made tremendous asset accumulation to around 178.6 trillion Rupiahs or representing 4.4 percent of the country's banking system's assets. This amount would be continuously expanding due to the potential size of markets and the most Muslim populous country in the world. This optimism aspiration was publicly stated and reaffirmed by Governor Central Bank of Indonesia, which argues "Islamic Banking has been positively growing over 2012 and yet remains to be persistently upgrading in the 2013". Meanwhile, in the case of Malaysia, according to the Economic Report 2012/2013 by Ministry of Finance, the Islamic Banking business was stated to have continued to expanding in the first seven months of this year with total assets increasing 20.6 per cent to

RM 469.5 billion, representing 24.2 per cent of the country's banking system's assets. In the 2013, Malaysian government has been continuously committed to improving banking performance by providing the new legal framework for Islamic banking and *takaful* operation. It may imply Islamic banking practices will have legal recognition to the contractual requirements in accordance with in Sharia. Therefore, Islamic banking development in both countries is gaining very great attention and calls for extraordinary analysis on to what extent then Islamic banking can cater and satisfy the needs of the *ummah* as the whole.

Graph 1: The Conventional Banking Development

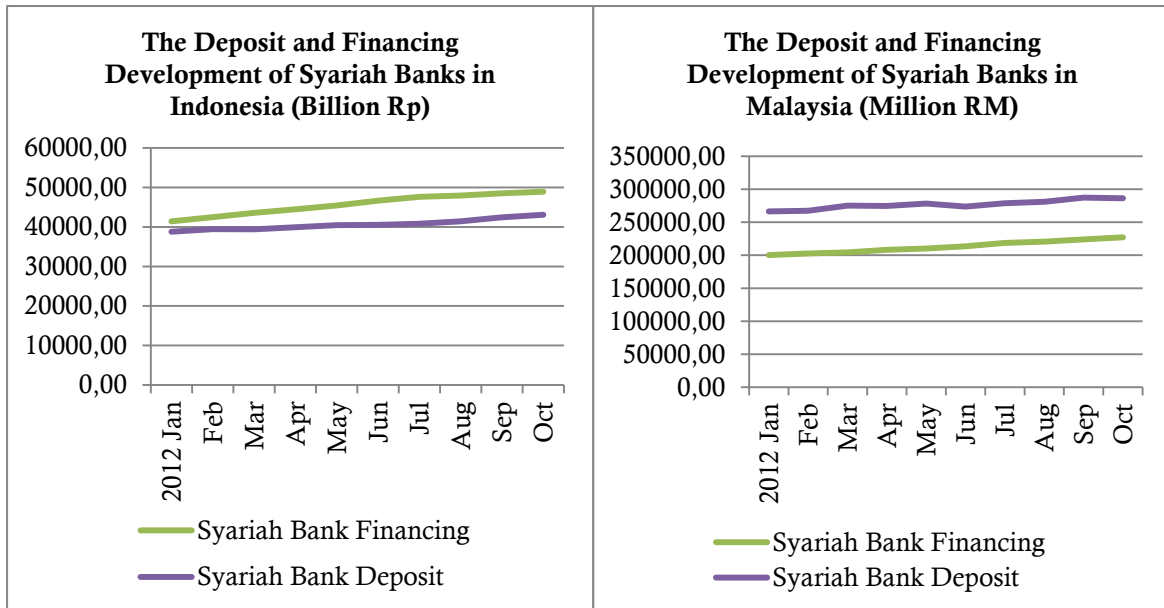


Source : Bank Indonesia and Bank Negara Malaysia (2012)

Graphically, the graph 1 below compares the development of conventional banking practices, either in Indonesia and Malaysia. In brief, we see that the progress, both in deposit and credit sides, has been persistently growing. However, in Indonesia, the amount of credit channeled exceeds the deposits side. Meanwhile in Malaysia is in contrast. It indicates that the liquidity reserves and capacity of Indonesia's banking sector is better off and the banking risk is no longer existence due to the strictly forced regulation by authority to keep up prudential banking principle.

Meanwhile, graph 2 shows that, in the case of Islamic banking, the amount of deposit exceeds the amount of financing in Malaysia, while Indonesia shows the opposite direction. In addition, in the case of Malaysia, the gap between financing and deposit seems to be widen until October 2012. Differently, in Indonesia the gap is smaller and the financing percentage seems to be larger over the deposited funds till October 2012. This situation is reasonable in the sense that Malaysia has more mature and highly developed market in Islamic Finance transactions and those subsequently open up the opportunity for banking system in Malaysia to be more efficient and highly expose more credible in terms of policies implementation. Nevertheless, given the trend that the financing side is narrowing over deposit in Indonesia, it has represented the fact that Indonesia's Islamic banks are gradually improving in terms of risk management and more efficient in conducting their businesses.

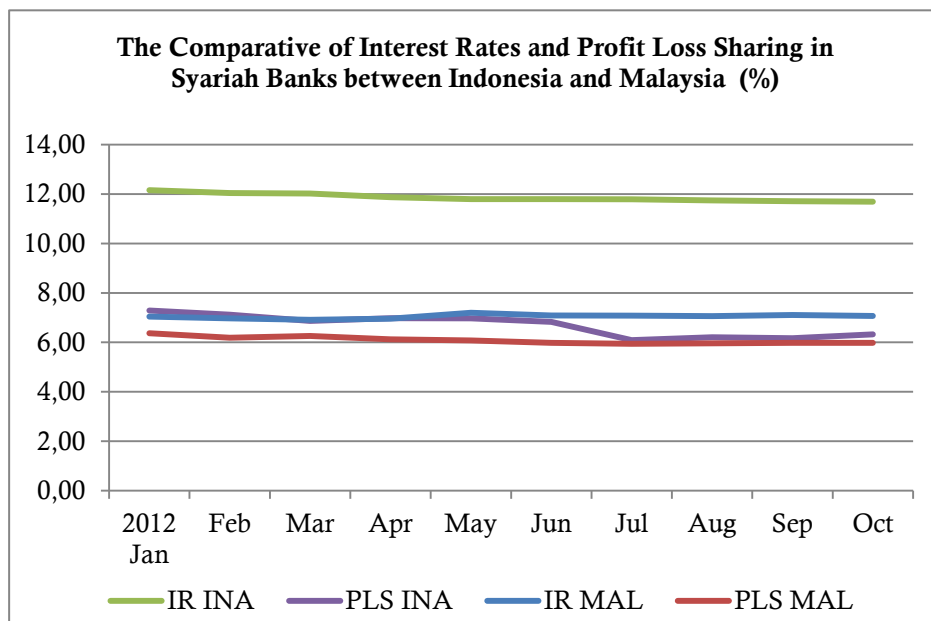
Graph 2: The Islamic Banking Development



Source : Bank Indonesia and Bank Negara Malaysia (2012)

In addition, graph 3 below shows that the spread, both in terms of interest rate credit and Profit Loss Sharing (PLS) in Indonesia, seems to be higher than Malaysia. It may trigger the capital inflows to Indonesia as the return of its capital is likely higher. However, the effect of spread return would be economically diminished once the customer behavior is not solely motivated by profit motive but by religious motion. In brief, the mature and awareness of depositing customers would influence the flows of capital between two countries.

Graph 3: The Interest Rate and Profit Loss Sharing



Source : Bank Indonesia and Bank Negara Malaysia (2012)

Additionally, it is very interesting then to look at the inter-link among the three GRAPHS above, particularly if associated with the existence of *maslahah* principles in the banking practices. In terms of conventional banks, obviously it shows that Indonesia's banks are more ambitious in channeling deposited funds rather than Malaysia's do. It could be happened because of the composition of theirs deposited funds is dominantly in the form of time deposits or long term deposited funds, instead of short term funds (demand and saving deposits). Therefore, it may create more rooms to bankers in managing theirs liquidity and ultimately avoiding from withdrawal and liquidity risks. In other words, putting the deposited funds into longer saving period would encourage conventional banks in Indonesia to pursue their credit expansion. Credit created which is according to Central Bank report channeled mostly to trade and manufacturing industry, all together made up around 50% per October 2012, would financially impact towards job and income creation. Ultimately, this thing would contribute towards the increase of *maslahah* due to presumably promoting their customer's welfare through credit creation.

In addition, in terms of the Islamic banking sector, Malaysia's financing account exceeds the deposited funds. It could be reasonable in the sense of the distinct features than of Indonesia's Islamic banking when it was established in the beginning. Indonesia's Islamic banking is developed from retail banking and less supporting system from central government. Therefore, it may face some difficulties and need some several stages towards an ideal Islamic banking system. Hence, nowadays, they prudently manage their liquidity by meanwhile catering both domestic and international markets with limited capacity. According to Islamic Banking Report in 2012, the human resources capability, the comprehensive regulatory framework, and a standardized banking practices are some of open challenging issues to respond immediately. In other words, we may expect that the highest amount of financing in Malaysia would generate proportional effect towards the increase of *maslahah*.

Subsequently, taking Malaysia experiences in developing Islamic banking which has been showing a tremendous share, it would be also interesting to look at the position of Islamic banking business under the Federal Government's policies earned it. The Government has been rendering its endless support for a continued and steady progress of this new industry. The last two decades of development since the first emergence of Islamic banking in Malaysia saw the vast creation of a wide range of products and services ranging from retail to corporate and investment banking products. The strategy Malaysia has been adopting is towards a comprehensive and effective Islamic financial system that is able to operate in parallel with the existing conventional system.

Based on the mentioned background above, the paper empirically tries to look at the current practices of Islamic banks, particularly on the deposit as well as financing side which are increasingly rising time by time. Given Islamic banking is complying with the principles of shariah, we expect then that all products and services issued are shariah compliant. This could be credible due to most of the Islamic Banks have established their Shariah Supervisory Board (SSB) whose duty is to advise the Islamic bankers in matter pertaining to the application of Islamic classical commercial rulings in the modern banking business. Hence, the depositors and banking behavior will be examined throughout the study by applying the rational concept combined with the utility maximization of consumer theory. However, unlike conventional banking, the attainment of *maslahah* is the main spirit of application of Islamic system in Islamic banking practices. In addition, given Indonesia and Malaysia are two neighbors which are highly promoting the Islamic banking practices, they are utilized as the object for observation throughout the study. Therefore, the main objective of the paper is to measure the degree of *maslahah* by taking Islamic banking as object of observations combined with utility concept under modern microeconomics perspective. In addition, looking through Malaysian Islamic banking who has been more developed than Indonesian's, then the paper discusses as

well the policy frameworks taken by Malaysia's government which have been accelerating Islamic banking institutions so that we may learn and apply them for Indonesian's.

The paper is structured as follows. Chapter two elaborates the theoretical and literature underpinning the concepts of rationality under Islamic perspective. Chapter three displays the data and methodology which are used to explain the mechanism in obtaining the final results. Chapter four demonstrates the findings and discussion. Lastly, chapter five ends with conclusion and recommendation.

Theoretical and Literature Review

Rationality Concept in Islam

Terminology of rationality is developed from everything that is acceptable logically and universally so that it does not need being tested, later called as axiom. In principle, rationality in Islam is ascribed from several axioms derived from Islamic tenets. The below concepts and axioms referred to Book entitled "Ekonomi Islam" written by Misanan et al. (2009). Some of axioms are as follows:

- a) The pursuit of *maslahah* in conducting every economic transaction. The high degree of *maslahah* is more preferable since it will generate bigger benevolence for human beings. In addition, *maslahah* has to be continuously pursued overtime (monotonic assumption).
- b) Non wasting behavior.
- c) Risk aversion or minimizing the risk, either worthed risk or unworthed risk.
- d) Uncertainty should be proportionally diminished as it can reduce the *maslahah*.
- e) Every economic agent tries to complete the information to minimize risk.

Ethics and Rationality in Islamic Economics

Principally, ethics is morally behavior accepted by social consensus. In Islam, ethics which later lead to rationality is social consensus based on *maslahah* concept. Therefore, Islam has a standard by its own which everything is not merely based on social consensus per se but the limit lined by shariah.

Application of Rationality in Islam

Before expressing the rationality model, we need to develop the observable variables along with their definition, and their role within developed model, namely:

- a) Lemma or axiom 1: *Maslahah* is the monotonic transformation of *falah*
 - Good Deeds (G) is every benevolence conduct of human beings
 - Bad Deed's (B) is activity which is not in accordance with sharia/Islamic tenets
 - M (G) is a such amount of *maslahah* reaped in the Hereafter if somebody does a good deed (G)
 - M (B) is such amount of *mafsadat* obtained once somebody undertakes unlawful deed (B)
 - Either M (G) or M(B) have the determined proportion though it could not be counted, but we expect $M(G) > M(B)$
 - Every good deed (G) will be bestowed God Salvation, vice versa for Bad deed (B).
- b) Lemma or Axiom 2: Every Good Deed will promote probability (π_g) for getting M(G) in Hereafter. In contrast, every bad deed (B) will have probability (π_b) to get M(B)

- Everyone is given ability (A) by Almighty Allah for executing such particular deed
- Everyone has the desire to undertake good deed (G) as well as bad deed (B). To prosecute such actions, everybody needs effort (E). In this context, E_g is an effort directed to achieve goodness, and E_b is directed to badness.
- c) Lemma or Axiom 3 : The big outcome requires for great effort, vice versa
 $G = f(E_g)$ and $B = f(E_b)$, $\Delta B / \Delta E_b > 0$, and $\Delta G / \Delta E_g > 0$.
 ➤ Every effort done by economic agents would be restrained by a certain level of ability upon him/her
- d) Lemma or Axiom 4: The same amount of effort and intensity will create the proportional results, either directed for Good deed (G) or bad deed (B)
 $\Delta B / \Delta E_b = \Delta G / \Delta E_g$ or $\pi_g = \pi_b$
- e) Lemma or Axiom 5: Due to the presence of *maslahah* lover, so that *maslahah* is no longer under diminishing marginal concept. It implies that $\Delta \pi_g / \Delta G > \Delta \pi_b / \Delta B > 0$.

Based on above axioms, we can deduce that (1) *maslahah* for good deed would rise once human being elevates the probability for conducting good deed as well as effort to do so, (2) meanwhile, *maslahah* for bad deed is present once somebody commits to increase probability as well as effort to do so.

The Maslahah Theory in Islamic Law

Literally, the word *maslahah* is derived from the verb “*saluha*”, which denotes a good, right, just or honest person or thing. Its antonym, *mafsadah* indicates anything that is harmful and destructive. The use of *maslahah* as an independent legal source has been advocated by many contemporary jurists and reformists such as Muhammad Abduh (d.1905), Rashid Rida (d.1935), Ibn ‘Ashur (d.1973) and Muhammad Sa’id Ramadan al- Buti. They support the principle based on the notion that Islamic law was revealed to serve, inter alia, human welfare (Lubis, 1995, p.10). Hence, all matters which preserve the well-being of the society are in line with the objectives of the shari’ah and therefore should be pursued and legally recognized. However, there was disagreement among the classical jurists in applying the *maslahah* principle as the determining factor in Islamic law. Due to the ambiguity in defining its limit (how far human welfare justification could be used to determine law), the classical jurists had differed in recognizing the validity of *maslahah* as a source of law. Some scholars claim that al-Shafi’i did not employ the *maslahah* as independent legal evidence (dalil) because he strictly confined the use of personal opinion (*ra’y*) to *qiyas* (analogy). According to al-Shafi’i, applying the concept of *maslahah* would exceed the limitations of permitted use of human legal reasoning in deducing new hukm (Lubis, 1995). Perhaps, al-Shafi’i attempted to portray his legal methodology (the Qur’an, sunnah, qiyas and ijma’) explained in al-Risalah as the self-contained sources of law which able to answer all questions in Muslim life. Al-Shafi’i believed that these sources of law are sufficient to cover the *maslahah* of human being. He thought the shari’ah takes full cognizance of all *maslahah* and there is no *maslahah* outside its framework.

Determinant of Islamic Bank Deposits

In general, the discussion about Islamic bank deposit is divided into three groups. First, is study which mainly focused on the rate of return of bank deposits and factors influence its volatility. Chong and Liu (2008) have attempted to show the relationship between Islamic bank deposit rates with conventional fixed deposit rate in Malaysia. Using time series data ranges between April 1995 to April 2004, Chong and Liu (2008) was able to provide evidence that rate of return in Islamic bank deposit is highly pegged to interest rate in conventional bank fixed deposit.

Secondly, studies which are directly discuss the amount of bank deposits and its determinants. Haron and Azmi (2008) uses macroeconomic variables as explanatory variables to predict the behavior of bank deposits in Malaysia and revealed that growth in the economy and an increase in money supply, composite index, and consumer price index, continue to increase Islamic bank deposits. Furthermore, Haron and Azmi (2008) also empirically proven that any increase in rates of interest, the volume of conventional bank deposits will increase and Islamic bank deposits will decrease, and vice-versa. Similar results are presented by Rohmah (2006) for Indonesia. Using autoregressive distributed lag approach, Rohmah (2006) provides evidence of long run cointegration between Islamic bank deposits with islamic and conventional rate of return on deposit, level of income and number of Islamic banks' branches. Haron and Ahmad (2000), additionally, examine the effects of conventional interest rates and rate of profits on funds deposited with Islamic banking system in Malaysia. The negative relationship emerged between the interest rate of conventional banks and the total deposits in Islamic banks provide evidence for the existence of the utility maximization theory among the Muslim customers.

Meanwhile, Kasri and Kasim (2009) provides similar conclusion for similar study done for Indonesia. It supports Haron and Ahmad (2000), Rohmah (2006), Haron and Azmi (2008) and Kasim et al (2009) by concluding that higher Islamic deposit is significantly correlated with higher rate of return and lower interest rate. Recently, Abduh et al (2011) studies the relationship between macroeconomic variables and financial crisis towards the fluctuation of total deposits in Malaysia Islamic banking industry. Using cointegration and vector error correction model techniques, Abduh et al (2011) evidences that inflation has negative effect towards total deposits. Whereas, other macroeconomic variables are not proven to have an impact on total deposits. Interestingly, financial crisis is significantly and positively affecting the Malaysia Islamic banking total deposits.

Third, is a group of studies which combine the discussion between rate of return on bank deposits and the volume of the deposits. Bacha's (2004) seminal work discusses causality relationship between conventional bank interest rate with Islamic banking rate of return as well as between conventional fixed-deposit and Islamic bank deposit. Using time series data spread from January 1994 to July 2003, the study shows that the changes in conventional banks interest rates and total deposits Granger cause changes in Islamic banks rate of return and total deposits respectively.

Zainol and Kasim (2010) examine the determinants of rate of return and total deposits in Islamic banking. Utilizing 10 years monthly data spread from January 1997 to October 2008, they found that Islamic banks' rate of return and conventional banks' interest rate are cointegrated and have a long-run equilibrium. Furthermore, the study also indicates the profit motive among the Islamic banks' depositors due to the significant impact of the *mudharabah* deposit rate with the total deposit and negatively significantly related with the changes in conventional fixed-deposit rate.

Data and Methodology

The study employs time series data spanning from January 2012 to October 2012. The data are obtained from Central Bank of respective countries, namely Indonesia and Malaysia. To gauge the rationality concept into reality, the paper uses the concept of utility by utilizing Cobb-Douglas function. In consumer choice model, Cobb-Douglas (CD) utility is widely used due to its simplicity and tractability, generating clear and testable empirical predictions. This function is empirically applied by inviting several variables, as follows:

- a) The *maslahah* concept clearly refers to utility which is counted as deed either denoting for good or bad. In this regards, we try to relate it with banking application in Indonesia and Malaysia. To determine M (G), the paper proxies "the ***financing***" activities channeled by Islamic banking as variable employed according to axiom (1)

above. It is because financing is the channeling available funds to the Islamic projects which ultimately could promote the benefit for human beings positively. Meanwhile, the credit variable is employed under conventional banking as a proxy for gauging M(B) due to the funds channeled by conventional banks do not somehow comply with sharia principles, for instance allocating funds for propelling unlawful projects, such as gambling, and intoxicant businesses. In brief, M(G) is measured by taking the amount of financing schemes channeled by Islamic banks over periods of observation. Similarly, M(B) is calculated by including the amount of credit distributed by conventional banks over periods of study.

- b) Subsequently, according to axiom (1) above, we need also to proxy for G and B variables. In the case of banking, the deposit side is utilized for measuring the rationality behavior on respective banking, both Islamic and Conventional. The use of deposit is rationale in the sense that the intention of customer in putting their funds whether in conventional or Islamic banks should be put in analysis. Once we have realized that only Islamic banks comply and fulfill the sharia principle, so then putting the funds on Islamic banks could be considered as good deed (G), vice versa. Therefore, the amount of deposit put by customers in Islamic banks is incorporated as good deed (G), meanwhile deposited funds in conventional is grouped as bad deed (B).
- c) The model also incorporates the probability of doing good or bad deed (π). In this respect, the paper puts the same weight for G and B, namely 0,5, in the sense that human beings are presumed of having proportional propensity in behave and making choice due to their own rationality.
- d) Last but not least, the inculcation of rate of return as the proxy for Effort (E) variable. Rate of return in the form of INTEREST is included for measuring Bad Effort (Eb), meanwhile the Profit Loss Sharing (PLS) concept is exercised for capturing Good Effort (Eg). The use of rate of return is basically a price of capital invested by depositors. Surely, once the funds are available in the markets, banks as intermediary institution intend to pool and distribute them based on profit motive transaction. Hence, the price of capital is commercially used to attract and absorb the funds in the market. Therefore, the price of capital which is called interest under conventional and profit loss sharing under Islamic concept are utilized and valued as kind of effort (E).

Finding and Analysis

Building Lagrange Function

- a) Under Marshalian Demand Function

In short, under this approach, the *maslahah* is going to be maximized subject to certain ability, represented by Effort (E) variables.

$$\text{Maslahah Function: } M = M(G)^{\pi g} M(B)^{\pi b}$$

$$\text{Ability Function: } A = E_g \cdot G + E_b \cdot B$$

Lagrange Function:

$$L = M(G)^{\pi g} M(B)^{\pi b} + \delta (A - E_g \cdot G - E_b \cdot B), \text{ we put the same weigh on probability } (\pi), \text{ namely } 0.5$$

$$L = M(G)^{0.5} M(B)^{0.5} + \delta (A - Eg \cdot G - Eb \cdot B)$$

Yields the first-order conditions:

$$\Delta L / \Delta G = 0.5 \cdot M(G)^{-0.5} M(B)^{0.5} - \delta Eg = 0 \dots\dots\dots(1)$$

$$\Delta L / \Delta B = 0.5 \cdot M(G)^{0.5} M(B)^{-0.5} - \delta Eb = 0 \dots\dots\dots(2)$$

$$\Delta L / \Delta \delta = A - Eg \cdot G - Eb \cdot B = 0 \dots\dots\dots(3)$$

Then equation (1) and (2) are simplified as:

$$(\Delta L / \Delta G) / (\Delta L / \Delta B) = (0.5 \cdot M(G)^{-0.5} M(B)^{0.5} - \delta Eg) / (0.5 \cdot M(G)^{0.5} M(B)^{-0.5} - \delta Eb)$$

$$\delta Eg / \delta Eb = (0.5 \cdot M(G)^{-0.5} M(B)^{0.5}) / (0.5 \cdot M(G)^{0.5} M(B)^{-0.5})$$

$$Eg / Eb = M(B) / M(G)$$

$$Eb = Eg (M(G) / M(B)) \text{ or } Eg = Eb \cdot (M(B) / M(G)) \dots\dots\dots(4)$$

Then, substituting equation (3) to (4)

$$A = Eg \cdot G + Eb \cdot B$$

$$A = Eg \cdot G + Eg (M(G) / M(B)) \cdot B$$

$$Eg \cdot G = A - (Eg \cdot (M(G) / M(B)) \cdot B)$$

$$G = (A - (Eg \cdot (M(G) / M(B)) \cdot B)) / Eg \text{ or } B = (A - Eb \cdot (M(B) / M(G)) \cdot G) / Eb \dots\dots\dots(5)$$

According to equation (5), we can draw the Indirect Utility Function as follows :

$$M = (M(G), M(B), A) = M(G, B) = ((A - Eg \cdot (M(G) / M(B)) \cdot B) / Eg)^{0.5} \cdot ((A - Eb \cdot (M(B) / M(G)) \cdot G) / Eb)^{0.5}$$

$$M = ((A - Eg \cdot (Eb / Eg) \cdot B) / Eg)^{0.5} \cdot ((A - Eb \cdot (Eg / Eb) \cdot G) / Eb)^{0.5}$$

$$M = ((A - Eb \cdot b) / Eg)^{0.5} \cdot ((A - Eg \cdot G) / Eb)^{0.5}$$

$$M = ((A - (A - Eg \cdot G) / G)^{0.5} \cdot ((A - (A - Eb \cdot B) / Eb))^{0.5}$$

$$M = (Eg \cdot Eb)^{0.5} \dots\dots\dots(6)$$

Under Hicksian Demand Function

In brief, the Hicksian assumes that maximization of *maslahah* has been in optimum point of scale. So that, we need to account the position of effort (E) which then leads to maximize the *maslahah*. The Lagrange function is used to calculate such position, as follows:

$$\text{Maslahah Function: } A = Eg \cdot G + Eb \cdot B$$

Ability Function: $M = M(G)^{0.5} \cdot M(B)^{0.5}$

Lagrange Function: $L = E_g \cdot G + E_b \cdot B + \delta (M - M(G)^{0.5} \cdot M(B)^{0.5})$

Yields the first order condition:

$\Delta L / \Delta G = E_g - 0.5\delta M(G)^{-0.5} M(B)^{0.5} = 0 \dots\dots\dots(7)$

$\Delta L / \Delta B = E_b - 0.5\delta M(G)^{0.5} M(B)^{-0.5} = 0 \dots\dots\dots(8)$

$\Delta L / \Delta \delta = M - M(G)^{0.5} M(B)^{0.5} = 0 \dots\dots\dots(9)$

Substituting equation (1) and (2)

$E_g/E_b = M(B)/M(G)$, where $M(B) = (E_g/E_b) \cdot M(G)$, and $M(G) = M(B) \cdot (E_b/E_g) \dots\dots\dots(10)$

Then, substituting equation (4) to (3),

$M = M(G)^{0.5} \cdot ((E_g/E_b) \cdot M(G))^{0.5}$

$M = M(G) (E_g/E_b)^{0.5}$, $E_b = (M(G)/M)^2 \cdot E_g \dots\dots\dots(11)$

Similarly applied to: $M = M(B)^{0.5} ((M(B) \cdot E_b/E_g))^{0.5}$

$M = M(B) (E_b/E_g)^{0.5}$, $E_g = (M(B)/M)^2 \cdot E_b \dots\dots\dots(12)$

Substituting equation (5) and (6) into $A = E_g \cdot G + E_b \cdot B$

$A = (M(B)/M)^2 \cdot E_b + (M(G)/M)^2 \cdot E_g$

$A = (M(B)^2 \cdot E_b + M(G)^2 \cdot E_g) / M^2$

$A = (M(G) \cdot E_g \cdot M(B) + M(B) \cdot E_b \cdot M(G)) / M^2$

$A = (M(G) M(B) (E_g + E_b)) / M^2$

$A = (M^2 (E_g + E_b)) / M^2$

$A = E_g + E_b \dots\dots\dots(13)$

Discussion

The discussion starts by elaborating the each equation, namely:

- a) Equation (4) and (12) indicates that effort directed for Bad deed (B) would generate a reduced *maslahah* (MG) and an increased *mafsadat* (MB). Therefore, the kind of effort has to be directed towards a Good effort (Eg) so that would minimize the harm in the society.
- b) Equation (5) implies that Good deed (G) could be achieved once the ability and the effort directed for good deed (Eg) is greater than the embedded intention to conduct bad deed (B), so that, ultimately it may minimize the *mafsadat* (MB)

- c) Finally, according to equation (6), the maximization *maslahah* under Marshallian demand function would be in place depending on the effort (E) pursued, either in the form of Good (Eg) or Bad (Eb). Hence, the *maslahah* would be dominant if the effort directed towards good deeds (Eg) is strived for by human being, particularly Muslims, vice versa. Meanwhile, shown by equation (13), under Hicksian demand function, the *maslahah* would remain maximize depending on the degree of effort done (E), whether dominant in the form of Good (Eg) or Bad (Eb) deed.

The Application of Rationality under Banking Practices

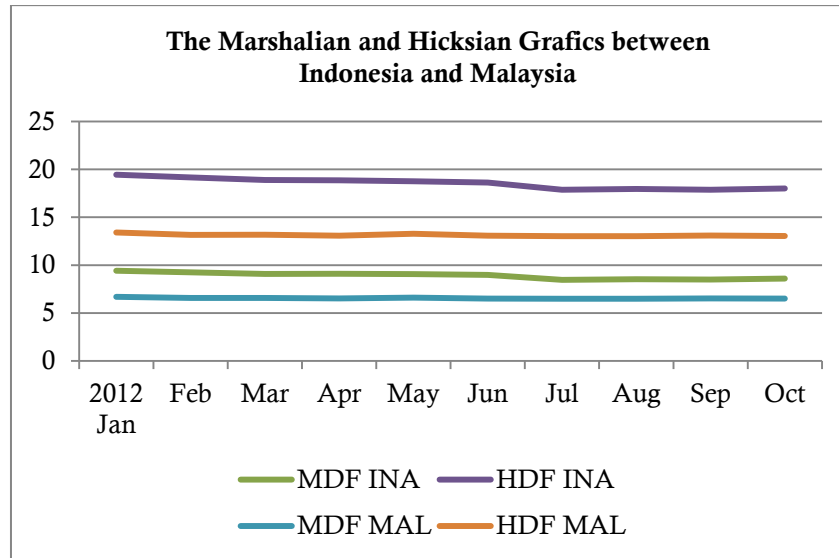
The graph 4 demonstrates the empirical numbers of Marshallian (MDF) and Hicksian Demand Functions (HDF) derived between Indonesia and Malaysia according to their respective Islamic banking practices. The results are interesting by taking an emphasize on, namely (1) in terms of the level of *maslahah*, Indonesian Islamic Banking is higher than Malaysia, (2) the higher effort is needed to be taken by Indonesia's Islamic Banks in order to remain maximizing the *maslahah* instead of Malaysia. Those above findings can be elaborated further by considering Islamic banking activities and share in both respective countries, as follows:

- a) By referring to definition of *maslahah* which is "all concerns that promote the subsistence of human life, the completion of man's livelihood and the acquisition of all his physical and intellectual qualities for him" (al-Shatibi, 1990, p.15). In other words, the obtained maximum benefit is the ultimate goal on why Islam, including Islamic banking should stand for. Therefore, if stated that Indonesia's Islamic banks share bigger *maslahah*, it does imply the practices of Islamic banks would have been giving more contribution to Islamic bank's customers through its products and transaction mechanisms. It is quite relevant to justify the bigger *maslahah* reaped by grasping the fact that Islamic banks in Indonesia are committed to the equity based contract rather than sale based contract. According to Central Bank of Indonesia's report per October 2012, the share of *musharaka* and *mudharaba* contract made up roughly 27.64 per cent out of total financing amount. Meanwhile, by taking the same contract applied by Malaysia's Islamic Banks, we get to know, it was around 5 percent under *mudharaba* and *musyaraka* contract financing per September 2012 released by Bank Negara Malaysia. Of course, we cannot just rely on this single reason on justifying that it is the cause of the lowest *maslahah* could be reaped in Malaysia. However, at least, Islamic banking activities in Indonesia are more concern on cooperative contract which could raise the degree of *maslahah* through their banking practices.
- b) In addition, given Indonesia's Islamic banks should be more struggles in order to constantly maintain the *maslahah* is highly taken into consideration. Given, its share just around 4.4 percent compared with conventional's asset and incomplete regulatory framework established in Indonesia's Islamic banking industry, would remain some challenging issues, beside the inadequate number of trained and skilled human resources available in market. Those weaknesses would ultimately refer to call immediately for the additional effort in order to maintain the maximum *maslahah* obtained by Islamic banking customers. In other words, eventhough, the *maslahah* in Indonesia is higher, but the infant and newly development sector are some concerted agreement among regulators, practitioners, and academicians to work out together for the complete structure and ultimately comprehensive contribution towards attainment of optimal *maslahah*.

The graph 4 demonstrates that by using Mashallian demand function, Indonesia seems to have greater number during the observation, namely in january for instance Indonesia had 9.4,

meanwhile malaysia 6.69. It implies that Indonesian Islamic banking bring greater masalah in respect to their practices through financing transactions, particularly perhaps to small medium businessess, compared with malaysian despite it has larger portion of assets. Additionally, in terms of Hicksian demand function, interestingly to see that Malaysia has bigger number over the period of observation. It indicates that a certain level of *masalah* in Malaysia was achieved by rendering a greater effort compared with Indonesia. It is reasonable in regard on a continous support from government towards Islamic banking development in Malaysia.

Graph 4: The Marshalian and Hicksian Demand Function in Indonesia and Malaysia’s Banking



Source : Author’s Calculation

Table 3: The Comparation Between Marshalian (Mdf) and Hicksian Demand Function (Hdf) between Indonesia and Malaysia

Year	INDONESIA		MALAYSIA	
	MDF	HDF	MDF	HDF
2012 January	9.41017	19.44	6.69663	13.41
Feb	9.25785	19.16	6.56843	13.16
March	9.08803	18.89	6.57697	13.17
April	9.10265	18.85	6.5265	13.08
May	9.06593	18.76	6.61634	13.28
June	8.97615	18.63	6.51139	13.07
July	8.47266	17.88	6.485	13.02
Aug	8.53896	17.95	6.48672	13.02
Sep	8.50025	17.88	6.52057	13.09
Oct	8.59747	18.01	6.5022	13.05

Source : Author’s Calculation

Policy Implications

Referring to above findings, the important point is that a continuous effort must be undertaken by Islamic banks in Indonesia to further improve *maslahah*. Meanwhile, looking at Malaysia which is nowadays becoming Islamic Financial Hub, then we may say that the efforts taken by Malaysia could be valuable references for developing and accelerating the *maslahah* concepts, particularly in Islamic banking. Therefore, we may take some of those Malaysia's experiences to elevate Islamic banking performances, specifically in improving the *maslahah*, namely :

a) The Shariah Framework

Central to the requirement of Islamic banking is the determination of the Shariah rulings on the operation and transaction by banks. Malaysia has adopted an institutionalised and systematic approach in setting up a Shariah framework for its Islamic banking system.

1. Structure

The Shariah Advisory Council (SAC) is the main central body and legally positioned as the sole Shariah authority for the "ascertainment of Islamic law for the purposes of Islamic banking business ...". In formulating the Shariah framework, it is structured that the SAC is at the apex of the Shariah framework and carries a heavy responsibility to safeguard the consistent application of Shariah and its integrity in the Islamic banking system in Malaysia. Complementary to this set up, there is also a requirement for Islamic banks to have their own Shariah committees under the Islamic Banking Act (IBA) to advise Islamic banks on the general day-to-day operations or the business of the bank. However, such Shariah committees do not have similar authority as that of the SAC. The advices and decisions of the Shariah Committee will not be final unless and until endorsed by the SAC. It is the duty of the Shariah committee to form preliminary findings or opinions at the banks and such findings or opinions will be submitted for further deliberation and endorsement by the SAC before such findings or opinions become valid Shariah rulings. In this way, any potential conflict of Shariah views will immediately be resolved and a more uniformity in decision on Shariah issues will also be achieved.

Taking cognisance of the fact that Islamic banking transaction is not purely Shariah matter but indeed they are commercial transactions which are based on Shariah, the membership of the SAC does not constitute Shariah scholars *per se*, but also made up of persons with other related experience in areas such as law, finance or banking. This could assist the SAC in achieving a wholesome deliberated decision that encompasses the whole spectrum of a banking product or operation.

2. Duties and responsibilities of the SAC

One major task of the SAC is to engage in *ijtihad*. *Ijtihad* is employed to arrive at a necessary ruling, based on the recognised sources of Shariah, the Qur'an and Sunnah. *Ijtihad* is an application by jurist of all his faculties either in inferring the rules of Shariah from their sources or in implementing such rules and applying them to particular issues.²³ It is a continuous process of development of the rules of Shariah as the divine revelation and Prophetic legislation had discontinued with the demise of the Prophet. The rules and methodology of *ijtihad* are well defined and the conditions of *Ijtihad* are well inscribed in Islamic jurisprudence. In fact there are also conditions required of a

mujtahid. Some of which are that he must be a Muslim, competent, of sound mind and with the necessary level of intellectual competence and the ability to form an independent judgement, apart from understanding the objectives of the Shariah (*maqasid al- Shariah*).

Ijtihad has to be validated by Quran and Sunnah and the dictate of reason (*aql*). *Ijtihad* remains to be an instrument of interpreting the divine message to relate to the changing requirement of the time, and its inspiration to attain justice and truth. In the aspect of Islamic banking transaction, this role is played by the SAC, as much of the modern banking issues are new and contemporary and may not be found in the classical times. *Ijtihad* plays a major role in the process of determining the valid and acceptable Shariah rulings for the contemporary Islamic banking.

Ijtihad inevitably will lead to *ikhtilaf* (juristic disagreement). In the face of different rulings produced through *Ijtihad*, the State under the principle of *Siasah Al-Shariah* is empowered to make a choice of the most suitable *ijtihad* to be used for the benefits of the Ummah. In the case of the rulings made by the SAC that lead to such differences in view, it is acceptable for Bank Negara Malaysia to make a choice of a preferred *ijtihad* taking into account the relevant factors.

In this sense the role played by the SAC is akin to the function of an Institutionalised *ijtihad* which is an idea found in the proposal of Muhammad Iqbal in his famous work, *The Reconstruction of Religious Thought in Islam*, where he proposed that to utilise *ijma* and *ijtihad* into the fabric of modern government, was to institutionalise *ijtihad* by making it an integral feature of the legislative function of the state. The SAC in offering advice to Bank Negara Malaysia to formulate policies in Islamic banking contributes towards the incorporation of the Shariah principles into such Islamic banking policies or even into the relevant legislative process. The reference by the court for a ruling of the SAC will also contribute to integrate Shariah law into the legal system of the country through the court process. This is a small step towards a more regulated and organised form of deducing and applying Shariah rulings.

Another important role played by the SAC is also to serve as the main Shariah Adviser to Bank Negara Malaysia. The Bank must consult SAC for guidance on Shariah matters relating to Islamic financial businesses. Thus, in formulating policies relating to Islamic banking business, SAC's advice on Shariah issues will help formulate regulatory and supervisory policies effecting the Islamic banks.

3. Corporate governance

To ensure the effectiveness of the above Shariah framework, corporate governance matters have been embedded into the law as well as in the guidelines issued to banks on the Shariah framework. Member of the SAC are prohibited by law to be a member of any of the Shariah committee at the bank to avoid potential conflict of interest.

The appointment of the members of Shariah committee at the Islamic bank requires the approval of Bank Negara Malaysia. A minimum criteria must be complied to occupy that membership. On the ground of banking secrecy a member of a Shariah committee of one Islamic bank cannot be a Shariah committee of another Islamic bank.

b) *Taxation Regime*

As earlier explained, the very nature of Islamic banking transaction, either sales based transaction, leasing or joint venture may attract more stamping and taxation costs. Issues on taxation and stamp duties are often cited as major hindrances to the development of Islamic banking transactions. Being a relatively new business in the market, they may not be within the contemplation of taxation regime around the world. Many times, due to its structure that may require more documentation, the Islamic banks will lose out or will incur more costs in doing business. It is inevitable that tax law should give due attention to Islamic banking transactions to even out the situations. In relation to this, the Law Review Committee has made a recommendation to reflect neutrality treatment of Islamic Banking transaction.

The Malaysian Government has always been adopting a neutral tax treatment between the Islamic banking transaction and the conventional banking. Now such policy is translated in a package of taxation laws which comprise the Income Tax Act 1967, Real Property Gains Tax Act 1976 and Stamp Act 1949. These tax laws adopt similar principles to signify the recognition on the peculiarity of Islamic banking business as compared with conventional banking. As an example subsection 2(8) of the Income Tax Act provides: “... any reference in this Act to the disposal-of an asset or a lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank ... as a scheme which is in a accordance, with the principles of Shariah, where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other scheme of financing”.

Pursuant to the above provision, a particular scheme of financing approved by the central bank as an Islamic banking product will trigger tax or stamp duty exemption. An Islamic banking product submitted for approval to Bank Negara Malaysia will also be assessed on tax and stamp duty implications. Initially the process will involve a tedious exercise of sieving through product by product before Bank Negara Malaysia upon consultation with the SAC, recommends any exemption. A committee has been set up to implement this process. Thus as an example, if a particular extra documentation is required solely for the purpose of meeting the Shariah compliant the committee upon the validation of the SAC will recommend exemption under the Stamp Act to the tax office.

c) *Issues and Challenges*

Despite its growth rate and extensive development Islamic banking in Malaysia is not free from the various issues and challenges. Some of which are discussed below.

1. Familiarisation on banking and Shariah

The main challenge that encounters many countries, Malaysia included, is to familiarise the Shariah scholars with commercial products, banking operations and practices and also familiarising bankers and lawyers with the Shariah principles. A meeting point of the two sides of spectrum will be crucial to facilitate a better development of Islamic banking. A comprehensive package of training is necessity and must be intensified. In Malaysia there are law schools such as the International Islamic University that provide training to the students and expose them to both the common law and the Shariah law. Similar training must also be intensified in areas of commerce.

2. Methodology

A lawyer will find the methodology employed by the Shariah scholar somewhat different, as Islamic laws are juristic laws as opposed to statutory laws. Finding statutory laws is never such a difficult task. Thus in a statutory law situation it is not too difficult to find the acceptable and the right interpretation based on the normal rule of interpretation or judicial precedent. Whereas, deducing Islamic law is itself a juristic process. The Qur'an and Sunnah are not mere code of laws but they lay out general guidance and prohibitions. Understanding the underlying principle and basis of this guidance and applying them to contemporary issues require a deep understanding of a particular prohibition and the objective that the Shariah wishes to achieve. Then the greater challenge will be to apply these virtues to the current need, time and the financial environment of the day. Very often, a lawyer who had to prepare the necessary documentation who is not able to appreciate the full impact of any particular requirement or injunction will find difficulty to reflect the Shariah intent in a clear manner. Sometimes Shariah issues are inserted as mere branding or by using some peculiar Arabic terminology to signify that they are Shariah compliant. Such method is too simplistic and will not achieve the intended virtues of Shariah.

3. Conventional Banking Mindset

The mindset and fixed ideas tide up with the current banking practice which somewhat occupy the bankers' mindset make it difficult for them to change their paradigm from the existing conventional product. There is always the temptation by bankers who are too familiar with the conventional banking product to superimpose the existing conventional marketable product with some superficial and literal interpretation of the *fiqh muamalat*. If this happens, then it will compromise the intended objective of the Shariah and its innate meaning. That is why a complete understanding of how a particular product is designed and what Shariah objective it is trying to achieve becomes one important knowledge required in the operation of Islamic banking. There has to come a time when Shariah scholar or Shariah banker is able to innovate an Islamic banking product that may break away from the present dichotomy of conventional and Islamic banking transaction.

4. Operating in dual banking system

Operating in a dual banking system has its own set of problems. Islamic banking products will always be compared with the equivalent conventional counterparts. There is a tendency for customers to expect for similar conventional products or services which they are more familiar with the Islamic banking transaction. On the other hand, if the Islamic banking product is based on similar features, then they will be claimed as imitations of the conventional products. The bigger challenge then is for the Islamic banker to educate their customer on its unique product and the necessary Shariah compliance.

In addressing some of the foregoing difficulties, Malaysia has intensified further efforts towards more researches and studies in Shariah relating to the banking transaction. At the first Annual Shariah Dialogue held at Kuala Lumpur on the occasion of the IDB conference mentioned earlier, Bank Negara Malaysia had pledged a sum of RM200 million to set up a fund to intensify researches, studies and dialogues in this area. A better understanding and more uniformity in the Shariah decisions internationally will foster the industry at the global front.

The role expected of IFSB will play a significant contribution in systemising the Islamic banking and converging them globally. Such efforts will eventually assist in converging the differences in understanding and interpreting Shariah issues for a possible uniform application of Shariah principles into their respective Shariah framework.

Conclusion

The paper empirically tries to implement the rationality concept under Islamic tenet by exercising the *maslahah* concept. By employing cobb-douglas (CD) function and taking Islamic banking practices as case study, the results suggest that the *maslahah* could be persistently promoted if the effort directed towards Good Deed (Eg) is highly pursued. In addition, the maximized *maslahah* could be also well-maintained once the good Effort (Eg) is dominantly embodied in every activity. Finally, by taking Islamic banking for applying the rationality concept, the study finds out that Islamic Banking in Indonesia has the higher level of *Maslahah* compared with Malaysia's Islamic Banking, but the continuous effort should be undertaken by Indonesia's Islamic Banks to maintain the maximum level of *Maslahah* through their practices.

Additionally, regarding to the Malaysian system, policy frameworks has to be accommodating to the operation and the transaction of Islamic banks. What it hopes to achieve is to see more assimilation and integration of the Shariah commercial law into in its legal system. A Shariah advisory body will further help supplement a conducive legal framework where the commercial laws will constitute the embodiment of both the common law as well as Shariah law to support and sustain the Islamic banking industry. All these will contribute towards sustaining Malaysia to remain at the forefront in Islamic banking.

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