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Constraints Framework for Fair Profit Distribution in Partnerships for Islamic Deposits: *A Critical Analysis of Literature*

Abstract *This study critically questions the PLS paradigm of Islamic banks in fair distribution of profits. PLS paradigm theoretically enforces that there should not be a significant difference between the returns offered to IAH and returns offered to shareholders. Smoothing of return can have a potential problem as IAH do not have any control over managerial decisions while banks owner equity is affected through absorption through displaced commercial risk. Therefore, this study analyzes the previous literature in a critical and systematic way to ascertain if Islamic banks are distributing profits in a realistic manner or there are some anomalies in the PLS paradigm of Islamic banks. Furthermore, the literature was analyzed critically to find out the associated factors and constraints that lead Islamic banks to impairment of PLS paradigm. Through analysis of the literature, smoothing of income and PDM is discovered in the empirical studies of different researchers. Furthermore, constraints to efficiently and effectively managing the fair distribution of profits have been identified in the literature. These constraints shape several factors, which are broadly categorized as banking characteristics, macroeconomic and financial environment, geographic and population characteristics; corporate and legal environment. A diagrammatic representation of constraints framework is suggested based on available literature. Furthermore, future directions for future research are provided at the end.*

Key Words: Profit Distribution Management, Profit and Loss Sharing, Income Smoothing, Constraints to PLS Model, Interest Rate

Introduction

Background of the Study

Islamic economic system puts into effect a fair system of distribution of wealth to ensure economic justice amongst different factors of production and sectors of economy (Usmani, 2002 Usmani, 2010). Thus, theoretically, Islamic finance as one of the pillars of contemporary Islamic economic system operates on the Shari'ah principle of profit and loss sharing (PLS), based on Musharakah and Mudharabah, which is assumed to endorse equitable distribution of wealth in comparison to the interest-based system (Mounira & Anas, 2008). The interest-based system is alleged unjust and promotes inequitable distribution of wealth resulting in creation of a class-based society (Usmani, 2002; Febianto, 2011; Kassim et al., 2009; Usmani, 2010). In an economy based on the interest the financier demands a fixed contractual rate of return irrespective of the financial outcome of the activities of the debtor (Grenuing and Iqbal, 2008). In practice, the liability side of Islamic banks operates purely on PLS basis in the form of contracts of Musharakah and Mudharabah (Sadique, 2010, 2010a, 2013). On the asset side, Islamic banks represent a mix of PLS products, including Musharakah and Mudharabah and markup based fixed return products largely using LIBOR/KIBOR as a benchmark including Murabahah, Ijarah, Diminishing Musharakah, Salam, and Istisna (Hassan and Lewis, 2007; Khan and Bhatti, 2008; Kassim et al., 2009; Sadique, 2010, 2010a, 2013; Febianto, 2011; Usmani, 2015). Although claiming PLS approach of doing business, Islamic banks are alleged to provide a rate of return which is consistent with either conventional deposit rates or benchmark rate which is based

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on interest-based system (Khan and Ahmad, 2001; Kaleem & Md Isa, 2003; Bacha, 2004; How et al., 2005; Haron & Azmi, 2008; Chong & Liu, 2008; Cevik & Charap, 2011; Zainol & Kassim, 2010).

PLS principle asserts that the real profits earned must be shared between the parties involved. Still, the Islamic banks offer profits which indicate profit distribution management (PDM) (Farook, Hassan, & Lanis, 2011; Abdul-rahman & Nor, 2016; Ashfaq et al., 2017; Chowdhury, Shoyeb, Akbar, & Islam, 2017). PDM is an ex post effect of the intermediary function performed by Islamic banks (Taktak, 2014; Farook, Hassan & Clinch, 2012; Siswantoro, 2017; Wafaretta, Rosidi, & Rahman, 2016; Hamza 2016). If Islamic banks are involved in PDM to the deposit holders, they are providing a shield to the deposit holders from risks that are associated with the bank's portfolio (Vitria, 2008; AlShattarat & Atmeh, 2016; Abid, 2017). However, when Islamic banks, in contrast to returns provided on the basis of the real outcome of PLS distributes a market-competitive return to the deposit holders, it puts into risk the investment of the equity holders of the bank i.e. the banks investment and shareholders wealth (Ariss and Sarieddine, 2007; Cihak and Hesse, 2008; Akkizidis and Khadelwal, 2008; Alhammadi, 2016). This risk-taking by equity holders in giving part of their profit to deposit holder despite of PLS contractual terms is known as Displaced Commercial Risk (Archer and Abdel Karim, 2006; Sundararajan, 2007; Kasri & Kassim, 2009; Ergec & Arsalan, 2013; Arshad, Zakaria, Sulaiman, & Irijanto, 2014). On the other side, based on the PLS nature of the contract, banks may engage in moral hazard activities by engaging in risky investments where the return, if high, may be shared by bank and deposit holders and losses if high will be borne by the deposit holders based on the nature of Mudharabah contract (Sundararajan, 2008, 2011; Archer, Karim, & Sundararajan, 2010; Ameer, Othman, & Mahzan, 2012).

Problem Statement

The PLS paradigm theoretically enforces that there should not be a significant difference between the returns offered to IAH and returns offered to shareholders (Archer & Karim 2012; Atmeh & Ramadan, 2012; Astrom, 2012; Muhammad Ayub & Ibrahim, 2013). Smoothing of return can have a potential problem, IAH do not have any control on managerial decisions while banks owner equity is affected through absorption through DCR (Sundararajan, 2007, 2008, 2011, Anuar, Mohamad, & Shah, 2014; Hamza 2016). PDM, also referred to as income smoothing if any, must be done with proper disclosure and in a transparent manner. This will decrease the moral hazard problem from the bank's side Hamza 2016). Here conflict of interest arises, and there are also issues of governance. In Islamic banks, the information asymmetry creates moral hazard problems related to agency theory when there is a high ratio of deposits in the banks. This calls for governance reforms in Islamic banks (Ashfaq et al., 2017). Therefore this study will analyze the previous literature in a critical and systematic way to ascertain if Islamic banks are distributing profits in a realistic manner or there are some anomalies in the PLS paradigm of Islamic banks. Furthermore, the literature will be analyzed critically to find out the associated factors that lead Islamic banks to put into practice or impairment of PLS paradigm.

Research Questions

1. Do Islamic banks follow the PLS system by sharing, with depositors, the actual profits earned?
2. What are the factors that cause Islamic banks to diverge from or converge towards the PLS system in distributing profits to depositors?

Objectives of the Study

A critical review of the literature has been conducted to achieve the following research objectives:

- To identify whether Islamic banks distribute profits to their deposit holders in line with the PLS principle, i.e., whether Islamic banks are directly sharing the actual profits earned or some kind of adjustments or management is performed before distributing profits to its deposit holders.
- To discover whether there are certain factors that allow Islamic banks to either share actual profits with its deposit holders or empower them to make any adjustments or management before distributing profits to its deposit holders.

Methodology

Research Design

A systematic approach was adopted to conduct this critical literature review. First of all, based on the research topic and roughly developed research questions, different search terms were used. Initially, the search word such as "Profit and Loss (PLS) sharing paradigm of Islamic banks" was used. In order to get a broader view of the theoretical perspective, broader terms were also used, such as "PLS paradigm of Islamic economic system" and "PLS paradigm of Islamic finance”. Furthermore, the term "paradigm" was replaced with the word "system," which made the term "PLS system of Islamic banks, Islamic economic system, and Islamic finance". As a result of these search terms, preliminary relevant research papers were identified. These initial terms resulted in more specific terms such as "Profit Distribution Management (PDM) in Islamic banks", "Income smoothing in Islamic banks", "Return smoothing in Islamic banks," and "Earning management in Islamic banks". However, based on the requirement of the research questions and objectives, we were more concerned about the profit distribution to the depositors; therefore, the articles based on earning management were set aside after initial study and understanding as these were not exactly relevant.

Research Databases

The most initial search was performed using google scholar, and after the selection of most relevant papers, the forward and backward referencing of those papers were used, which were considered most relevant. These searches were also performed using Elsevier, Springer, Science Direct, and Web of Science. A problem which is normally faced while performing research in the area of Islamic banking is that research on Islamic banking is not easily found in the topmost journals of management; therefore, rather than adopting the method using specific journals, research papers were used from the searches of databases. Using the search terms and forward and backward citation, the research articles were collected until repetition was noted and saturation was formed. In addition, a few authors were also identified as having expertise in the area of PDM and were thoroughly selected for the literature review process.

Selection and Rejection Criteria

Selection and rejection criteria were used using the most relevant papers to PDM and return smoothing. At the earliest of the stages, papers were selected or rejected after having a complete reading of the whole article. Once an understanding of the theory was developed, papers were then easily selected and rejected using the article's title and abstract. Where required, the methodology chapter and variables used were identified to either select or reject papers.

Different folders were developed based on the search terms such as PLS, PDM, income smoothing, return smoothing, and earning management. Based on these search terms, preliminary relevant research papers were identified. These initial terms resulted in more specific terms. However, based on the requirement of the research questions and objectives, we were more concerned about the profit distribution to the depositors; therefore, the articles based on earning management were set aside after initial study and understanding as these were not strictly relevant.

Based on the early reads, the papers were put in to folders most relevant, relevant and irrelevant. Within the most relevant folders, the papers were segregated based on the timescales. The latest and the most basic were then put into the folders of the first read, second read, and so on. The latest was read first to get an updated sight of the empirical evidence and theory. The earliest and most basic ones were given second priority to getting an understanding of the basic theory.
Finally, the literature was assessed critically.

Analysis of Literature

Profit Distribution Management, Natural & Artificial Smoothing

(Farook, Hassan & Clinch, 2012) defines profit distribution management as the managing process of distributing profits to deposit holders in such a way that the bank provides return parallel to market interest rates, irrespective of the actual outcome of the transactions. As per PLS contracts, Islamic banks have an explicit obligation to share actual profits with deposit holders but, Islamic banks implicitly manage profits in such a way that they distribute returns parallel to market interest rates. This makes the rate of return to deposit holders away from return on equity (ROE) and return on assets (ROA).

Rachman & Siswantoro (2017) has defined PDM as sharing of profit performed by Islamic banks in allocating profits to its customers according to agreed ratio. It must be kept in mind that in the study of Rachman & Siswantoro (2017) the author has identified different relationships, which seems a bit confusing. Because PDM has been defined as the allocation of Profit-sharing according to the agreed ratio, the effect of other variables has been shown differently. Sometimes the relationship is shown as if PDM is the distribution of profit away from the asset return, and sometimes the relationship of different variables with PDM is shown as if PDM is allocation of profit towards asset return. Indonesian banks highlight PDM is the process of distributing profit to its depositors based on the ratio of profit sharing agreed at the onset of the contract (Isa & Rashid, 2014).

Taktak (2014) investigated the smoothing of income as well as the nature of smoothing in Islamic banks, i.e. whether natural smoothing or artificial smoothing is performed in Islamic banks. Taktak (2014) argues that when a natural process of doing banking through intermediation process produces a stream of income which gives a normal pattern of income, such smoothing of income is known as natural smoothing. However, if the manager intentionally modifies the income stream through their decision process by deliberate allocation such a smoothing is identified as artificial smoothing.

Risk-based Profit Sharing between Parties in Islamic banks

Frequent questions are raised on the extent of risk-sharing between the parties and subsequent sharing of profits between the parties based on the risk assumed by each (El-Din, 2008; Farook, Hassan & Clinch, 2012). Furthermore, questions are raised on the possible reasons of managing the distribution of profits when contractually different parties have agreed for PLS. Sundararajan (2007) argues that a strong process of measuring, controlling, and disclosure of the bank equity risk with profit-sharing investment accounts (PSIA) can be a source of strong risk management in Islamic Financial Institutions (IFIs). Through the inclusion of risk-sharing of PSIA with banking equity, regulating authorities can provide relief as well as a powerful tool for risk mitigation (Farook & Farooq, 2013; Lahrech, Lahrech, & Boulaksil, 2014; Athari, Adaoglu, & Bektas, 2016). This can be made possible by the incorporation of PSIA in overall bank capital for the measurement of capital for risk management (Archer, Karim & Sundararajan, 2012). Sundararajan (2007) reasons that Islamic banks must distribute returns based on the risk profile of each investor, whether a deposit holder or a shareholder. The researcher analyzes the issues of risk calculation so that the problem of sharing return based on risk-return tradeoff can be identified and solved. This risk measurement is addressed with reference to unrestricted and restricted account holders and banks, however, the measurement of risk for restricted account holders is addressed with reference to a specific asset in which the investment is made.

Sadique (2013) argues that investment account holders (IAH) have an inherent feature of PLS ability in the contract. This ability of IAH to absorb losses provides an incentive to Islamic banks to take high risks and make high-risk investments on funds of IAH. Due to PLS contractual terms, Islamic banks have the incentive to get involved in moral hazard, adverse selection, and agency problems. As a result of the inability of IAH, this requires monitoring of Islamic banks due to no governance rights. However, similar problems of information asymmetry, moral hazard, and agency problems exist on the asset side between the IB and clients (Kamarudin & Ismail, 2013; Hamza & Saadaoui, 2013; Isa & Rashid, 2014; Hamza 2016; Korkut & Ozgur, 2017). This risk from the asset side is then transferred to the deposit side (Binti Syed Agil, Alhabshi, & Rahaman, 2011; Astrom, 2012)

Based on this analysis, it is recommended that proper disclosure of all the risks faced by PSIA must be given. Based on this disclosure, a risk-return profile with different products should be offered to the customers.

The next section outlines the factors that affect the possible PDM. These factors are identified from the critical review of literature on profit-sharing in Islamic banks.

Constraints/ Factors Affecting PDM in Islamic banks

Farook, Hassan & Clinch, (2012) analyzes the factors affecting PDM quiet laterally. They investigated the asset side factors for PDM as well as the liability side factors that may affect the PDM in Islamic banks. On the liability side, which has been mentioned as the demand side for Islamic banks because the expectations of the returns from Islamic banks may come from the depositors (Farook, Hassan & Clinch, 2012; Rachman & Siswantoro (2017). Therefore, the characteristics of depositors may affect the PDM of Islamic banks either towards the interest-based market benchmarked rates or away from interest-based market benchmarked rates if real income earned is shared between the parties (Farook, Hassan & Clinch, 2012; Rachman & Siswantoro (2017). Different factors on the demand side and supply side which affect PDM in Islamic banks are discussed below.

Banking Characteristics

The literature has identified different characteristics of the banking industry, which enforces a bank to either perform PDM or enforces it not to perform PDM. These aspects are the type of products used by Islamic banks at the financing side or asset side, the age of the bank, capital adequacy ratio (CAR), and the proportion and effectiveness of the funds collected by the bank. This section discusses these characteristics and their relationship with PDM

One of the aspects of Islamic banks PDM may be a result of the supply side of the balance sheet, i.e., the asset side of Islamic banks. In practice, Islamic banks largely use debt like instruments in the form of deferred sales and agreements based on rentals and leasing. These contracts largely fix the rate of profit based on the prevailing interest rate at the time of executing the sale or lease. This is because Islamic banks largely use interest-based benchmarks such as LIBOR\KIBOR to determine its fixed profit. These loan like contracts will bind Islamic banks in fixed profit, and any change in the prevailing interest rate will force them to offer a competitive market return hence making Islamic banks perform PDM (Bacha, 2004; Mounira, 2008; Khalid & Hamdouni, 2011; Usmani, 2015; Wafaretta, Rosidi, & Rahman, 2016). Islamic banks such as Mudarib derive a large amount of revenue as Mudarib Fee. This Mudarib fee increases with the increase in depositor base. So the banks with a large depositor base in relation to the shareholders will be largely dependent on the depositors and will be inclined towards providing a competitive market rate of return (Farook, Hassan & Clinch, 2012). However, when the banks are less dependent on depositors for earning revenue where the ratio of the depositor to shareholders is low. In such situations the banks are not inclined towards PDM Hamza 2016; Wafaretta, Rosidi, & Rahman, 2016); Rachman & Siswantoro (2017)).

Age of Islamic banks is another factor that plays a role in determining PDM. At the early stages of Islamic banks, it will be necessary for them to build investor confidence, therefore at the initial stages of commencement, banks will be more inclined towards providing returns compared to market rates. Therefore new banks will be actively performing PDM, and with period of time, as they develop depositor confidence with age, the activity of PDM may decline (Farook, Hassan & Clinch, 2012; Wafaretta, Rosidi, & Rahman, 2016); Rachman & Siswantoro (2017). As against (Farook, Hassan & Clinch, 2012), this study of (Rachman & Siswantoro (2017) proposed a negative relationship between the PDM and age of banks.

When a bank has a high capital adequacy ratio, it means that the bank has sufficient capital to safeguard itself against any possible risk of losses. Rachman & Siswantoro (2017) defines Capital Adequacy Ratio (CAR) as the provision of enough capital which may be capable of absorbing the losses incurred to banks. When banks have sufficient capital, it is in a safe condition and can perform PDM wider from the asset return giving a positive relationship between PDM and CAR.

Rachman & Siswantoro (2017) argues that as a result of the effectiveness of third party funds, Islamic banks may earn high profits and high return, but in case of a large fund, the bank may face a liquidity problem and therefore a negative impact on PDM. Therefore, third-party fund effectiveness will inversely affect PDM (Wafaretta, Rosidi, & Rahman, 2016).

Rachman & Siswantoro (2017) identifies a negative relationship between PDM and Third-party funds proportion. This is based on the argument that Islamic banks with high deposits will tend to distribute profit towards asset return, and therefore, there is a negative relationship.

Farook, Hassan & Clinch (2012) theoretically identified a positive relationship between PDM and Deposits but found a negative relationship empirically, which implies that large deposit holders control the banks to provide actual asset returns.

Role of Reserves as Shields to Deposit Holders

In the presence of risk factors and variation in returns, banks use Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR) to perform income smoothing or PDM to Depositors (Sundararajan, 2007; Taktak, 2011; Farook, Hassan & Clinch, 2012; Htay and Salman, 2013; Hamza 2016; Siswantoro, 2017; Wafaretta, Rosidi, & Rahman, 2016). In this process of Income smoothing the use of PER, which is a reserve taken out of the profits of Deposit holder and equity holder both, creates a shift of equity holder income to the depositor holders giving rise to DCR (Archer and Abdel Karim, 2006; (Sundararajan, 2007); Kasri & Kassim, 2009; Ergec & Arsalan 2013) already discussed. As a result of a constant supply of higher return to depositors above the actual return, Islamic banks are posed to DCR and restrict them to provide higher return consistently. DCR creates a liquidity problem as well (Hamza 2016). (Sundararajan, 2007) analyzes that as a result of least developed Islamic markets and instruments along with problems of liquidity and lack of creditor right due to profit and loss sharing arrangements in Islamic banks, Islamic banks are more exposed to its unique types of risk in comparison to the risks faced by their conventional counterparts. This crucial problem of liquidity management can be solved through the development of Islamic money and capital markets along with the implementation of proper governance with all inbuilt procedures and controls of information systems, accounting, reporting, and legal infrastructure. (Sundararajan, 2007) affirms that Islamic banks use reserves such as PER to control the variations in return to the deposit holders. Such reserves are used to manage returns to investment deposit holders to provide rates that are parallel to market deposit rates. Thus, these reserves help to reduce variation and risk in depositor return. Similarly, IRR is used to provide a comparative return in periods of losses to the deposit holders. IRR is a portion of reserve taken out after the profits once the profit of equity holders is completely deducted. Therefore, PER is taken out of the profits of both the investor (Deposit Holder) and Mudarib (Bank), while IRR is the profit of investors (Depositors) only. As PER is a ratio of return on assets, there is a direct correlation between asset return and PER. However, the policy of using PER by the bank and its ratio on asset return is one of the determinants of measure of risk. The procedure of determination PER and its use for return smoothing is one of the main factors for determining the relationship between risk to depositors and aggregate bank risk (Sundararajan, 2007).

Disclosure on PER and IRR is very limited and cannot be clearly found in the financial statements of Islamic banks (Sundararajan, 2007; Taktak, 2011; Farook, Hassan & Clinch, 2012; Hamza 2016; Siswantoro, 2017; Wafaretta, Rosidi, & Rahman, 2016). Htay and Salman (2013) argue that AAOIFI, IFSB, and Bank Negara Malaysia are a few of the institutions that are providing guidelines to enable Islamic banks perform competitively with parallel conventional banking systems. One of the most significant guidelines of Islamic banks is the guidelines with regard to PER and IRR. To cope with the risk, the three financial institutions involved in developing regulations and guidelines for Islamic banks proposed guidelines for reserves that can be set aside and used in situations for maintaining stable profits these reserves were PER and IRR. These reserves are thought to prevent equity holders as well as used as a shield towards systemic risk. PER and IRR protect Islamic banks against DCR, Reputational risk, and withdrawal risk (Ramli, Shahida, & Ismail, 2012). Through the establishment of reserves such as PER and IRR, Islamic banks absorb these shocks using these reserves. AAOIFI requires IFIs to disclose the percentage amount which should be used to deduct reserves such as PER and IRR.

The existence of reserves play an important role in PDM. It is much possible for shareholders to decrease their unsystematic risk through the process of diversification in comparison to the deposit holders who are not in a position to diversify their risk as a result of the nature of a deposit in banks. However, despite diversification the bank will not want a deterioration in the value of assets as a result of increase in cost due to riskiness of bank returns. These reserves shield Islamic banks and investors against such volatility. So in the presence of these reserves, Islamic banks will be more inclined towards PDM as it will be feasibly possible for them to perform such management.

The other tools used by Islamic banks for return smoothing is loan loss provision as identified by (Taktak, Zouari, & Boudriga, 2010; Taktak, 2014). PER and IRR are general provisions, while loan loss provision is a specific provision to write off against banking assets (Farook, Hassan & Clinck, 2014Farook, Hassan & Clinch, 2012). Another way of smoothing return in Islamic banking is the transfer of shareholders' part of the profit to the IAH (Taktak, 2014). Furthermore, the part of unremunerated deposits, if invested with lower risk and lower return, will produce a stream that can be used by Islamic banks to have excess return which can be used for stabilizing of return.

Effect of Macroeconomic variables

Researchers asserts that economic conditions have an inverse impact on the PDM. This is because in an economic downturn, the performance on assets of Islamic banks i.e. financing contracts of Islamic banks, may perform poorly, which will cause Islamic banks to manage their profit by providing competitive rates to their depositors when it is not actually possible (Haron & Azmi, 2008; Cevik & Charap, 2011; Farook, Hassan & Clinch, 2012). These returns may be a result of the shift of return from shareholders towards deposit holders or even a shift of Mudarib part towards deposit holders. This implies that a recession in the economy may give rise to DCR in Islamic banks. In the periods of high losses, the provision for losses in the form of nonperforming financing (NPF) may also increase. Rachman & Siswantoro (2017) argues that due to inflation the customers of Islamic banks may demand higher rates due to high costs. However, they postulate a negative relationship between PDM and Inflation as against (Farook, Hassan & Clinch, 2012) who postulate a positive relationship between PDM and Inflation. In recessionary situations the bank may face the problem of bad debts and therefore an adjustment to PDM. Therefore, the researchers postulate a negative relationship between GDP and PDM

Status of Financial Development in the Market

It is argued that in developed financial markets, there is no information gap and as a result of good information availability there is investor confidence. However, in poor and undeveloped financial markets there is lack of investor confidence, therefore in such markets, the investors are not ready to undertake risky investments due to information asymmetry (Farook, Hassan & Clinch, 2012; Farook, Hassan & Clinch, 2015; Wafaretta, Rosidi, & Rahman, 2016). Based on the assumptions in developed financial markets the investors will have confidence on the outcome of Islamic banks and will not be bothered on the return which is below market rate as they have the confidence that in good times they will be compensated through a good return (Grenuing and Iqbal, 2008; Cevik & Charap, 2011). Therefore, in poor financial markets, Islamic banks perform PDM activity to ensure investor confidence as investors may switch as a result of lower return due to information asymmetry in the markets (Farook, Hassan & Clinch, 2012; Hamza 2016).

Islamic banks operating in dual banking system have the competition pressure from Islamic as well as conventional banks (Khan and Ahmad, 2001; How et al., 2005; Kaleem & Md Isa, 2003; Bacha, 2004; Haron & Azmi, 2008; Chong & Liu, 2008; Cevik & Charap, 2011; Zainol & Kassim, 2010; Farook, Hassan & Clinch, 2012). However, if Islamic banks present a larger part of the overall banking system, this will make it possible for Islamic banks not to manage their profit and offer the real return to the investor. This is because Islamic bank does not feel the pressure of offering equivalent rates to conventional banks as a result of higher concentration (Farook, Hassan & Clinch, 2012); Wafaretta, Rosidi, & Rahman, 2016). If banks have a low market share along with high deposits this puts the bank in an uncertain position with respect to its return and in these cases, Islamic banks use discretionary reserves to perform return smoothing and postulates a negative relationship for Market share with PDM (Wafaretta, Rosidi, & Rahman, 2016).

Demographics

Farook, Hassan & Clinch, 2012), postulates that if the depositors of Islamic banks are religious, the rate of return will not be a matter of concern for them and hence there will be lower pressure on Islamic banks to perform PDM and vice versa. Firstly, the group of depositors who are more concerned about the religiosity rather than return are termed as Islamic Loyalist. The second group of depositors identified are those who are indifferent between religiosity and rate of return, and are termed as floating segment. Those who are purely concerned about the rate of return rather than religious commitment are termed as price sensitive. So in any financial market, the level of the PDM will depend on the type of customer in the prevailing market (Farook, Hassan, & Clinch, 2014, 2015). If the market contains Islamic loyalist, then banks will not be concerned about the return, and there will be lesser PDM. Conversely, in the case of floating segment and price-sensitive segment, the bank will be concerned about the rate provided to these customers, and there will be more PDM.

Furthermore, familiarity of the depositor with the Islamic and general banking principle is another important area. They further argue that if the depositor of Islamic banks are aware of the underlying principles of Islamic banks, this will not induce them to switch banking as a result of lower rate of return, rather they will be aware that in periods of boom they will be compensated due to the PLS nature of contract based on higher returns. This will make Islamic banks not to perform PDM. However, if the depositor is not familiar with the principles of Islamic banking, this will make him switch immediately amongst banks based on the market return, and this will make Islamic banks perform PDM for such depositors (Farook & Farooq, 2011).

Rachman & Siswantoro (2017) also argues that the intention towards use of Islamic banking deposit has not been Islamic rather it has been a motivation for maximization of wealth. Islamic depositors switch between Islamic and conventional banks based on higher return or rate of interest. Studies have identified a strong co-integration between Islamic banks profit sharing and interest rate claiming these to be interest based. This relationship between Islamic banks profit sharing and interest rate cause Islamic banks to perform PDM (Khan and Ahmad, 2001; How et al., 2005; Kaleem & Md Isa, 2003; Bacha 2004; Haron & Azmi, 2008; Chong & Liu, 2008; Cevik & Charap, 2011; Zainol & Kassim, 2010).

Governance

The prevailing governance system in Islamic banks is not efficient enough to address the unique governance issues of Islamic banks (Ayub, 2013; Ayub & Ibrahim, 2013). The governance right to IAH can control this moral hazard and high risk involvement of Islamic banks. IAH may not have a religious motive and maybe a segment which is return oriented. So in a situation where Islamic bank due to poor performance is not able to pay competitive return to IAH, IAH may switch to other banks. As a result to cover the risk of withdrawal Islamic banks may perform income smoothing (Farook & Farooq, 2013)

Magalhaes & Al-Saad, (2013) argues that governance rights to depositors will put pressure on banks to perform strict and disciplined monitoring to control information asymmetry and moral hazard problems along with agency issues on the asset side. Looking at this overall picture, it can be seen that as a result of PLS, a new agency problem has come into existence between IAH and IB which is similar to agency issues between shareholders and IB. However in Islamic banks the shariah board largely perform governance management for IAH protection in addition to general governance which is performed by the board of Directors (Toumi, Viviani, & Belkacem, 2011; Mollah, Hassan, Al Farooque, & Mobarek, 2017; Safiullah & Shamsuddin, 2018).

It is observed that governance mechanisms and policy for the management of risk can be significant contributors towards safeguarding Islamic banking depositors (Hamza 2016).

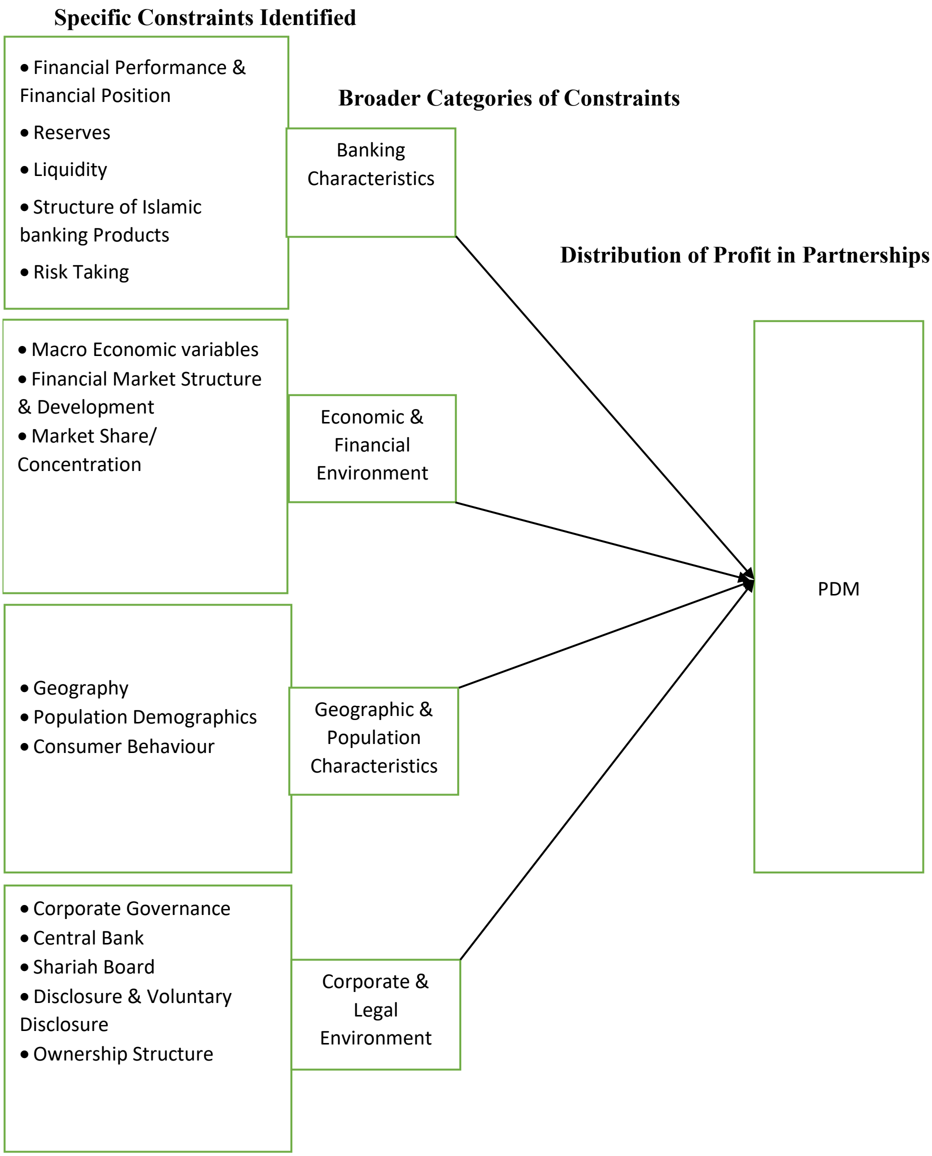

Figure 1: Framework for Constraints in PDM in Islamic Banking

Conclusion

Islamic banking model places its foundation on the justified distribution of profit as per the risk sharing phenomena. It claims that a predetermined rate of return in the form of interest promotes an unjust economic system leading to inequitable distribution of wealth leading to a class based society. Conversely, Islamic economic system through Islamic banking presents a risk sharing model of profit and loss sharing. Islamic Jurisprudence through Quran, Sunnah and Fiqh lays down specific rules for distribution of profit amongst different parties. A violation of these rules either prohibits the legality of profit earned as per Islamic law and jurisprudence or leads a transaction to generation of interest and gambling. In this global world with modern banking and financial system Islamic banking needs efficient system to identify the legality of a transaction from Shariah point of view to distinguish Islamic system of finance from conventional interest based system. However, theoretically Islamic banking claims to function on the basis of profit and loss sharing adhering to the rules of shariah in order to eliminate the element of interest gambling and uncertainty in business transaction but the analysis of literature shows that Islamic banks are involved in PDM. The analysis of the literature exhibits that there are several constraints to fair distribution of profit in partnerships of Islamic banks. Broadly these constraints can be categorized as banking characteristics, macroeconomic factors, geographic and population demographic and governance factors. Literature provides different relationship of these factors with PDM. These findings pose threats to the profit and loss sharing model of Islamic banks which must be immediately addressed to distinguish Islamic banking system from the conventional system. Management and Shariah boards of Islamic banks need to devise strategies to ensure fair distribution of profit as per Musharakah, Mudharabah and Wakalah models. However, there is still a debate between the classical and contemporary models, but the elimination of interest, gambling, uncertainty and other deviations from the enforcement of these contracts must be ensured to keep Islamic banking distinct from conventional banks.

Further studies and reviews can be conducted to identify other factors affecting profit distribution in Islamic banks. Comparative analysis can be done between pure Islamic banks and Islamic banking branches of conventional banks. Other factors such as the role of capital, tax effects, pandemic effect and financial crisis can also be investigated by researchers.

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