

## Effect of Government Policies on Internal Control Systems and *Musharakah* Growth: Perspective from KP, Pakistan

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The poor growth of *musharakah*-based finance in the context of Pakistani Islamic banking is the main motivation behind this study. The literature identifies several factors for this poor growth. Among these, the direct influence of internal and external factors on the application of *musharakah* has gained crucial theoretical and empirical support. This study aims to identify the influence of internal control systems (internal factor) via the moderating role of government policies (external factor) on the growth of *musharakah*-based finance in Pakistani Islamic banking. To begin with, this study uses exploratory factor analysis (EFA) to identify the underlying structure of items, and PLS-SEM to identify possible effects on data collected from 92 respondents. Results indicate the existence of partial moderation at a 10% level of significance ( $t\text{-value}=1.876$ ,  $p\text{-value}=0.061$ ). Since this paper tests the moderating variable, develops a theoretical framework, and uses Smart PLS 3 as methodological contributions improving upon existing literature. The study concludes by identifying future research opportunities and considering other variables with mediating effects.

**Keywords:** *musharakah*; growth; internal control systems; government policies; PLS-SEM

Prolonged fluctuation in the *musharakah*-based finance in Pakistani Islamic banking is an issue of great concern. Table 1 reveals unsatisfactory %age growth of *musharakah*-based financing, despite increasing with every year. According to Farooq and Ahmed (2013), this growth is negligible. In December 2007, the total financing value of Pakistani Islamic banking was PKR108 billion, out of which *musharakah*-based financing was valued at PKR1.68 billion (=1.55%). In 2010, total gross financing stood at PKR190.2 billion, to which *musharakah* contributed PKR5.5 billion, with a share of 2.9%. In 2011-12, the share of *musharakah*-based financing decreased to PKR2.4 billion and PKR0.8 billion. From 2013 to March 2015, the percentage of *musharakah* has seen a continuous increase. However, the percentage increase in *musharakah* growth is not encouraging when compared to diminishing *musharakah* (DM) from PKR137.7 billion in December 2014 to PKR147.9 billion in March 2015 (Islamic Finance Bulletin, Dec 2006-March 2015).

Research literature identifies a number of theoretical and empirical factors that are critical to the success of *musharakah*-based financing. Examples of these key factors include unavailability of mechanisms of checks and balances, unsupportive government policies, incentive problems, high costs of monitoring, accounting problems, complex nature of *musharakah* contracts, inadequate sources of income, agency problems, effect of inflation, low level of expertise, deposits short-term nature, poor management, dominance of and competition with other conventional banks, low rate of return, entrepreneurs' unwillingness to share profit, *shari'ah* issues, operational difficulties, poor internal control systems, risks inherent in *musharakah*-based financing, weaker auditing, high taxes, etc. (Khan, 1995; Dar & Presley, 2000; Ismal, 2008; Gafoor, 1995; Promwicheit 2014; Samad et al.,

2005; Al-Harran, 1999; Maniam et al., 2000; Fabianto & Kasri, 2007; Ascarya, 2009; Nafis & Rasyad, 2014; Hanif, 2014; Muda & Ismail, 2010; Khan & Bhatti, 2008; Islam, 2008; Ismal, 2013; Ahmed, 2006; Farooq & Ahmed, 2013. Among these factors, the direct influence of internal and external factors has gained crucial support. Therefore, this study aims to identify the key role of government policies on the relationship between internal control systems and the growth of musharakah in Pakistani Islamic banks as Hadi (2017) in his recently reviewed article identified government policies as a major contributing factor towards the growth of KP SMEs.

Research literature on the subject claims that Islamic banks and their modes of finance – especially profit-and-loss-sharing modes (*mudarabah* and *musharakah*) – are considered as the most authentic modes of finance. There is theoretical and empirical proof that these modes of financing are inherently more stable, which helps prevent prolonged business fluctuations. So far, however, Pakistani Islamic banks failed to incorporate *musharakah* and *mudarabah* modes of finance into their business activities comparatively (Muhammad, 2016). The importance of such modes of finance – especially *musharakah-based* finance has also been recognised by *shari'ah* scholar Maulana Muhammad Taqi Usmani. Muhammad (2016) highlights that empirical evidence on factors affecting the growth of *musharakah-based* finance in Pakistani Islamic banks is limited. He also added that far too little studies on the growth of *musharakah-based* finance has been carried out. According to Farooq and Ahmed (2013), it is necessary to empirically inspect the practical aspects of *musharakah-based* finance that can decrease risk and positively and significantly affect the performance of Pakistani Islamic banks.

**Table 1**

*Gross Financing, Musharakah Financing and Diminishing Musharakkah of the Islamic Banking Industry in Pakistan (Rs. in billion)*

Years	"Dec 2006"	"Dec 2007"	"Dec 2008"	"Dec 2009"	"Dec 2010"	"Dec 2011"	"Dec 2012"	"Dec 2013"	"Dec 2014"	"March 2015"
Total Gross financing in (B)	65.7	108.2	146	158.6	190.2	211.8	242.1	330.2	422.1	417.8
Financing in Musharakah in (B)	0.533	1.68	2.64	2.8	5.5	5.1	1.9	22	46.5	47.6
Share of Musharakah in (%)	0.8	1.55	1.7	1.8	2.9	2.4	0.8	6.7	11	11.39
Financing in diminishing musharakahRs (B)	10.59	27.73	44.81	48.2	56.1	69.9	87.5	101.8	137.7	147.9

Source: Islamic finance bulletin, Dec, 2006-March 2015.

## Review of Literature

### *Factors Influencing Musharakah Financing*

Literature to date on Islamic modes of finance has focused holistically rather than specifically on musharakah-based financing Muhammad (2016). Therefore, it can be deduced that there has been little arguments on factors influencing the growth of musharakah-based financing. However, Al-Harran's (1990) demonstrates the positive attitude of managers in Sudanese Islamic Bank's is significant to their success. Similarly, the investigative work of Jalaluddin (1999) concludes that bankers role in the application of PLS-based finance is considerable. In another similar study, Boubah (2009) found that monitoring capabilities and high level of control over debtors are critical factors for stable operation of Islamic banking. Therefore, it can be argued in the present study that lower

monitoring of these factors attain lower performance. From a semi-structured interview, Zamil (2014) found that the key problems to the growth of Islamic financing are: “*dual-banking environment*”, “*inadequate provision from the regulatory framework*”, “*shari’ah non-compliance*”, “*internal control system*”, “*lack of strategic human capital*”, “*lack of accountability with poor accounting practices*”. To predict and comprehend attitudes of Libyan business firms, retail consumers, and banks toward the use Islamic methods Gait (2009) uses reasoned action theory. Similarly, to investigate financial institutions challenges and opportunities in the context of Islamic bank in UK, Karbhari et al., (2004) conducted “*focused interviews*” for financial institutions in London. Also, Abdullah and Rahman (2007) examine factors such as; knowledge, understanding of Islamic banking, and awareness in the context of Malaysia. Nevertheless, very little study in the context of Pakistani Islamic banks and more specifically, no empirically study in the context of KP Province has conducted to address these issues. Therefore, this study tried to address this issues by taking internal factor (i.e. internal control system) and external actor (i.e. government policies) into consideration.

### ***Internal Control System (ICS)***

Zaheer (2013) argues that an effective internal control system (ICS) is important for the stable operation of Islamic banking. Ali (2013) says that ICS is vital for Islamic banking, as they increase transparency within the organisation. Al-Harran (1990) suggests that the management of Islamic banks should consider the implementation of *musharakah* funding not only for small farmers but also for their employees working with farmers in the field to give them a greater incentive to remain in rural areas and with the bank. Aisyah (2014) claim that Islamic modes of finance reduce the asymmetry of information and costs of the transaction through proper supervision and monitoring. Thus, due to the asymmetry of information, monitoring and surveillance are important in Islamic banking. According to Sarkar (1999), Islamic banks did not have experienced and trained personnel for the assessment, monitoring, and evaluation of projects which are necessary for financing. Another important consideration for the growth of *musharakah-based* finance is a lack qualified personnel in financial institutions, which results in the weakness of internal control systems (Maniam et al., 2000). Ismal (2008) emphasises that Islamic banks should formulate their organisational approach to address issues related to financing and funding.

Dar and Presley (2000) argue that an appropriate follow-up mechanism for PLS is to be created by the Islamic banking and financial industry. Chapra (2007) argues that self-regulation in the financial system can improve its quality. Managers can share risks associated with the bank by an increasing dependence on equity and debt reduction, as desired by the great religions. Zamil (2014) accomplishes that feeble internal control systems may create operational risks which negatively affect the performance of Islamic banks. Al-Harran (1990) argues that the continuous success of *musharakah-based* finance is contingent on the quality performance of top management. Therefore, in light of the above discussion, it is hypothesised that:

H1: *There is a statistical significance between the internal control systems of Islamic banks and the growth of musharakah finance.*

### ***Government Policies (GP)***

For the proper operation of Islamic banking systems some Islamic countries still have poor infrastructure Zeller (2014) while some banks experienced complications in their operation due to unclear government policies. He explains, Malaysia is regarded as a complete infrastructure to support the work of Islamic banks, but unfortunately, Malaysian Islamic banks still faced problems with regard to the “*legal and regulatory framework*”. In the same vein Directors, employees, and *shari’ah* scholars have expressed concern regarding the lack of government policies to support the

development of *shari'ah*-based products. Aisyah (2014) insist that for stable operation of Islamic banks regulatory system needs to be improved.

Sarker (1999) contends that the performance of Islamic banks can improved if they are supported by appropriate banking laws and regulations. According to him, one of the reason Islamic banks do not use PLS in Bangladesh is that they are not supported by Central Bank. The importance of "*banking laws and regulations*" for the stable operation of Islamic banks is also emphasised by Chapra (2007). To encourage innovation and facilitate proper contracts appropriate regulations are required (Iqbal & Mirakhor 1999). Muhammad (2016), Archer et al., (1998), Karim (2001) and Errico and Farahbaksh (1998) examine problems associated to the regulations of Islamic banking systems. They posits that proper regulatory system depends on information disclosure and accounting standards. Baubah (2009) found inadequate legislation as a basic caused. He also highlights that the taxation department is an important government agency that Islamic banks must pay close attention to. Al-Harran (1990) and Mangla (2014) also highlighted the key role of government policies for the success of *musharakah*-based finance. Shafiai and Moi (2015) projected that the government needs to develop appropriate policies for the betterment of Islamic banking systems. However, these arguments relies too heavily on qualitative and descriptive analysis. Thus, to examine the interactive role of government policies empirically in KP Islamic banks, it is hypothesise that:

*H2: The relationship between internal control systems and musharakah growth is at least moderated through government policies.*

## Method

This study uses convenient, non-probability sampling technique. Data were collected in the province of Khyber Pakhtunkhwa, Pakistan. Respondents included top and middle level bank managers, mainly those directly involved in decision making processes. Self-administered questionnaires were used for data collection, respondents were asked to rate their level of agreement and disagreement on 5-points Likert Scale. To test construct validity- convergent and discriminant, exploratory factor analysis (EFA) was conducted using SPSS version 25. PLS-SEM was used to test the hypothesised effects.

## Results

### PLS

The SEM technique by means of SmartPLS 3.0 was used for data analysis (Ringle, 2013). PLS allows estimation of data from a relatively small sample size (Chin, 1998). Since our sample size (n=92) is relatively small, therefore this study used PLS-SEM for data analysis.

### Unidimensionality

To classify the original structure of items for internal control systems, government policies, and *musharakah* growth, the current study conducted exploratory factor analysis (EFA) with principal component analysis and oblique (oblimin) rotation method. Tables 2 and 3 summarise the EFA results. The suitability of the data for factor analysis was assessed by KMO and Bartlett's Test of Sphericity. The value of KMO is 0.804, above the threshold of 0.5. The value of Bartlett's of Sphericity is also significant at 0.000.

**Table 2**  
*Test for suitability of data for factor analysis*

KMO			0.804
Bartlett's Test of Sphericity	Approx. Chi-Square	733.942	
	df	153	
	Sig.	0.000	

Source: Own survey results

56.5% of the variance is attained for three factors (i.e. internal control system, government policies, and musharakah growth). The eigenvalue for internal control system scale is 5.741 which explains 32% of the variance. The eigenvalue for the government policies scale is 3.065 and explains 17% of the variance. The eigenvalue for the *musharakah* growth scale is 1.365 and explains 7.5% of the variance. These three factors emerged by using oblique rotation principal, as proposed by Kim and Mueller (1978), Schmitt (2011) and Hadi et al., (2016). The factor identified above through EFA was used as an input in SmartPLS 3 for testing the measurement and structural model (Figure 1).

**Table 3**  
*Factor loadings, Cronbach's Alpha, Composite Reliability and AVE*

Items	EFA Loadings	Standardized loadings	alpha	Composite Reliability	AVE
<b>Internal Control system</b>					
IC1					
IC2	0.708	0.842	0.856	0.893	0.584
IC3	0.691	0.764			
IC4	0.698	0.601			
IC5	0.798	0.779			
IC6	0.667	0.805			
	0.849	0.805			
<b>Government Policies</b>					
GP1	0.775	Removed			
GP2	0.814	0.778	0.871	0.906	0.706
GP3	0.832	0.834			
GP4	0.842	0.924			
GP5	0.851	0.819			
<b>Musharakah Growth</b>					
MG1	0.663	0.741			
MG2	0.657	0.744	0.750	0.824	0.504
MG3	0.667	0.572			
MG4	0.613	0.620			
MG5	0.616	0.544			
MG6	0.535	0.566			
MG7	0.611	0.627			

Source: Own survey results

### Assessment of Measurement Model

The internal consistency of the constructs was evaluated by composite reliability (Henseler et al., 2009: 299). All CR values were above the threshold of 0.7 (Table 3). This confirms that all constructs possess satisfactory internal consistency. Results also showed that the value of AVE for three scales ranged from 0.504 to 0.706 (Table 3). This demonstrates that the scales used for the internal control system, government policies, and *musharakah* growth possessed convergent validity.

**Table 4**

#### Discriminant Validity Results

	Government policies	Internal control system	Musharakah growth	Moderating effect
<b>Government Policies</b>	<b>0.841</b>	--		
<b>Internal control system</b>	0.523	<b>0.764</b>	--	
<b>Musharakah growth</b>	0.052	0.478	<b>0.635</b>	--
<b>Moderating effect</b>	0.126	0.119	0.131	<b>1.00</b>

Source: Own survey results

Table 4 shows that all diagonal values (the square root of the AVE) exceed inter-construct correlations, demonstrating that all constructs possess discriminant validity. The present study also assessed discriminant validity by the Henseler et al., (2015) criterion (Table 5), and found that discriminant validity was ensured, since the upper confidence interval limit is below 1. The HTMT inference criterion indicates that all HTMT values are significantly different from 1. Therefore, discriminant validity is established.

**Table 5**

#### HTMT (Inference Criterion) for Discriminant validity

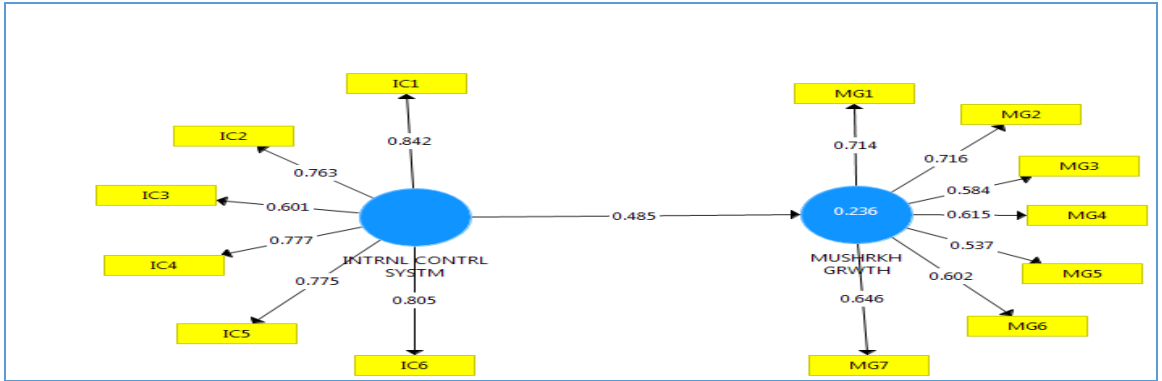
	Original sample	Sample mean	2.5%	97.5%
Internal control system → Government policies	0.614	0.617	0.413	0.778
Musharakah Growth → Government policies	0.582	0.590	0.360	0.818
Musharakah Growth → Internal control system	0.363	0.367	0.128	0.643
Moderating effect → Government policies	0.170	0.265	0.146	0.434
Moderating effect → Internal control system	0.145	0.234	0.093	0.506
Moderating effect → Musharakah Growth	0.098	0.146	0.046	0.311

Source: Own survey results

### Structural Model

The results of the structural model are presented in Figures 1, 2, and 3. The direct effect of internal control systems on *musharakah* growth are statistically significant (Figure 1), and the value of  $R^2$  is 23.6%. After introducing government policies as a moderating variable, the value of  $R^2$  increases from 23.6% to 33% (Figure 2). Figure 3 shows that government policies moderates the relationship between internal control systems and *musharakah* growth. This hypothesis is only partially supported, as the t-value is 1.876, with a p-value of 0.061, significant at the 10% level (Table 3).

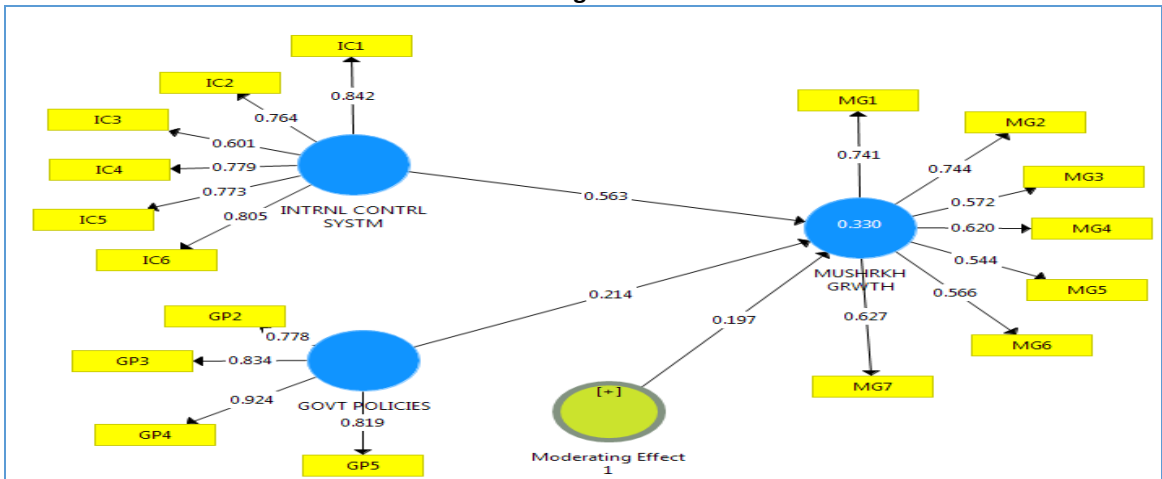
Direct effect



Source: Own Survey Result

Figure 1

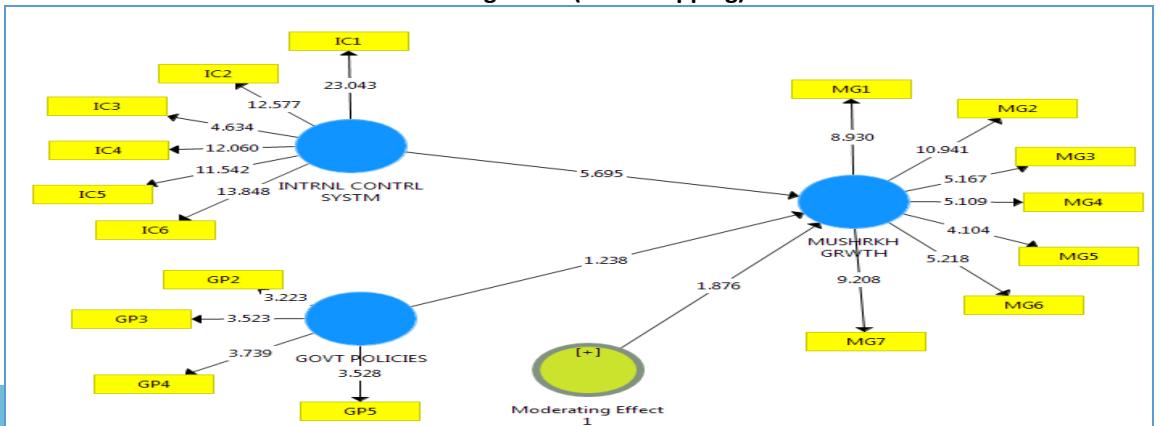
Moderating effect



Source: Own Survey Result

Figure 2

Moderating effect (bootstrapping)



Source: Own Survey Result

Figure 3

**Table 6**  
*Path Coefficients*

Paths	B	SE	t-values	p-values
Government policies → Musharakah Growth	0.214	0.173	1.238	0.216
Internal control system → Musharakah Growth	0.563	0.099	5.695	0.000
Moderating effect → Musharakah Growth	0.197	0.105	1.876	0.061

Source: Own research results

**Table 7**  
*Hypotheses Results*

	<i>Hypothesize relationship</i>	<i>p-values</i>	<i>t-values</i>	<i>Conclusion</i>
<b>H1</b>	There is a statistical significance that internal control system affects Musharakah Growth	0.000	5.695	Supported
<b>H2</b>	The relationship between internal control system and Musharakah growth is moderated through government policies	0.061	1.876	Supported

Source: Own research results

## Discussion

### *Conclusion and Contributions*

This study originates with the prolonged fluctuation of *musharakah-based* financing in Pakistani Islamic banks. Based on existing literature, the study hypothesises the influence of internal control systems on *musharakah* growth through the moderating role of government policies towards Islamic banking. The study found a positive and significant relationship between internal control systems and *musharakah* growth, with an  $R^2$  value of 23.6%; this indicates that internal control system explains 23.6% of the variance in *musharakah* growth. Secondly, the study introduces an interacting variable between these two effects and found that government policies do moderate the relationship between internal control systems and *musharakah* growth. The nature of this moderation was partial since the preceding relationship between internal control systems and *musharakah* growth was still significant after the interaction effect with 10% level of significance. Finally, the study concludes that *musharakah* growth depends on the internal control systems of Islamic banks, along with government support. The more government support there is, the greater will be the possibilities of *musharakah* growth in Pakistani Islamic banking, specifically in the province of KP.

Findings from this study add to our current knowledge on *musharakah* growth by providing new statistical evidence. Via the direct and indirect effects of internal control systems and government support, this study has provided a more holistic understanding of *musharakah* growth.

### *Implications for Practice and Research*

These findings have implications for future research concerning *musharakah* and the management of Islamic banks. The current study identify that internal control systems must be effective and efficient for *musharakah* growth. Outcomes from this study also confirm that the interaction of government support in the growth of *musharakah* mode finance is crucial.



With this knowledge, the management of Islamic banks can take effective decisions regarding internal control systems and can propose modalities of government support for the growth of *musharakah* financing.

### **Limitations and Future Research**

The sample of the current study is limited to the province of KP. Future research may expand on these findings by considering other provinces. In the present study, only perceptual data from bank managers were collected to test the hypothesised effects. To broaden the scope, future research should consider other stakeholders.

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**Internal control system**

- IC1 Our bank's internal control system for *Musharakah* based financing is very strong.
- IC2 Our bank actively participates in the business activities of its partner in *Musharakah* financing to avoid high risk.
- IC3 Our bank recognizes the market situation of the business when profit ratio under *Musharakah* contract is fixed with the partner.
- IC4 The approval of *Musharakah* finance loan applications are based on the market situation.
- IC5 The attitude of senior officials (top management) towards *Musharakah* financing plays a significant role in the application of *Musharakah* financing.
- IC6 In our bank the *Musharakah* method is a more effective monitoring of loans financed.

**Government Policies**

- GP1 The government policies are favorable to *Musharakah* mode of financing.
- GP2 The *Musharakah* method may have serious tax problems (R).
- GP3 Special regulatory guidelines are lacking to encourage *Musharakah* financing (R).
- GP4 The government provides subsidies and allowances to support the customers who Prefer *Musharakah* financing.
- GP5 Too many and too frequent changes in the Government policies may affect the application of *Musharakah* financing.

**Musharakah Growth**

- MG1 In our bank the *Musharakah* method is a more effective monitoring of loans financed.
- MG2 Repayment of debt is easily controlled under *Musharakah* in our bank because the bank is a financial partner in the business.
- MG3 Compare to other modes of Islamic finance the growth rate of *Musharakah* is quite satisfactory
- MG4 *Musharakah* based financing remained the most preferable mode of financing in our bank during the last five years
- MG5 *Musharakah* is the most appropriate tool of financing in our bank
- MG6 In our bank there is a constant increase in the approval of *Musharakah* loan applications during the last five years.
- MG7 In our bank mostly customers are asking about the features of *Musharakah* financing compares to others.

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