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Profit-Loss Sharing in Islamic Banking: Global Insights from a Systematic Review

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Abstract

Islamic banking emerged as a response to the limitations of interest-based financial systems, offering alternative models rooted in Shariah principles—chief among them the profit-and-loss sharing (PLS) mechanism. This study re-examines the implementation of PLS in Islamic banks, identifying key challenges and outlining directions for future research within the framework of Shariah-compliant financial practices. Employing a systematic literature review of Scopus-indexed journal articles, the study compares theoretical foundations and empirical evidence surrounding PLS applications in contemporary Islamic banking. Findings indicate that PLS practices remain only partially aligned with Shariah principles, constrained by insufficient regulatory oversight, heightened credit risk, and moral hazard concerns. The study also identifies critical gaps in community awareness and operational management, underscoring the need for product innovation, stronger governance structures, and targeted educational initiatives. These insights point to three strategic priorities for stakeholders: enhancing governance to mitigate moral hazards, integrating macroeconomic policy support to improve PLS scalability, and expanding public education to close knowledge gaps. Together, these measures can support a more sustainable, equitable, and competitive Islamic banking sector.

Keywords: Governance; Islamic Banking; Mudharabah; Musyarakah; Profit-Loss Sharing.

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Introduction

Islamic banking has undergone significant development since the establishment of the first Sharia-compliant bank in Egypt in 1963. Today, over 50 countries have adopted Islamic banking systems, with particularly strong growth in the Gulf Cooperation Council (GCC) region (Zainuldin, 2020; Ousfama et al., 2020). A key turning point came with the collaboration between the International Bank for Trade and Development and the Federation of Islamic Banks in the 1970s, which introduced a new paradigm centered around the concept of Profit-Loss Sharing (PLS) to the banking world (Biancone et al., 2020;Syahri & Harjito, 2020; Agriyanto et al., 2022). This model, rooted in the contracts of Mudharabah and Musyarakah, distinguishes Islamic finance from conventional banking by rejecting *riba* (interest), aligning instead with principles of justice and social welfare Kaddour et al., 2021).

The vision of promoting economic justice and welfare through Profit-Loss Sharing (PLS) is both logical and appealing (Junaidi, 2022a; Jedidia, 2020; Yaya et al., 2021). Nevertheless, it is surprising that, despite the strong potential and positive reception of PLS financing by customers—particularly in Muslim-majority countries—its actual implementation remains significantly lower than that of non-PLS financing instruments (Ibrahim et al., 2022; Farihana & Rahman, 2021; Amar & Alaoui, 2023). The application of PLS contracts, including Mudharabah and Musyarakah, continues to lag behind, representing only a small portion of total Islamic bank financing (Berniz & Maulida, 2022; Suzuki & Miah, 2023; Mutamimah & Kartika, 2023). Chong & Liu (2009) and Nor & Ismail (2020) report that in Malaysia, PLS financing accounts for only 0.5% of total financing, despite significant growth in Islamic banking assets between 1983 and 2004. Similarly, Abdul-Rahman et al. (2014) found that the average annual percentage of PLS financing in Malaysia was just 3% of total financing. This pattern has also been observed in other countries—including Bangladesh, Jordan, Nigeria, and Pakistan—where, from 2013 to 2022, PLS financing consistently comprised only a minor share of the overall financing landscape (IFSB, 2023). Several constraints have been identified as contributing to this underperformance: (1) asymmetric information between banks and clients, which leads to adverse selection and moral hazard; (2) risk-averse behavior among depositors, who tend to favor fixed-return products over profit-sharing models; (3) lengthy financing contract durations, which introduce greater uncertainty and liquidity risk; and (4) weak legal enforcement mechanisms for defaulters, which diminish contract credibility and increase institutional risk (Azmat et al., 2015).

These findings raise several important questions regarding the implementation of profit-loss-sharing (PLS) financing in Islamic banking. In particular, they prompt further inquiry into the challenges that may hinder its popularity compared to other financing methods. Research conducted by Buchari et al. (2015) indicates that many employees in Islamic banks possess a strong understanding of Islamic financing principles. However, other studies suggest that limited interest in PLS financing may stem from persistent issues related to asymmetric information. This challenge may also be exacerbated by insufficient government policy support for the adoption of PLS mechanisms within Islamic financial institutions. As demonstrated in Malaysia—where robust governmental intervention has significantly accelerated the growth of Islamic banking—appropriate policy frameworks play a critical role in sectoral development. Alternatively, advancements in technology, such as digitalization and increased transparency, offer potential pathways to reduce problems related to asymmetric information (Sapuan, 2016). This concern is further validated by Lessy et al. (2021), who confirm that agency problems are inherently linked to PLS financing. Using Bayesian game analysis, researchers observed that banks tend to prefer lower-risk, lower-return contractual arrangements, especially when agents are perceived as inefficient. Such preferences reflect broader risk-averse behavior and a focus on minimizing yield volatility in financial decision-making. Similar risk-related findings have been identified in the context of Islamic microfinance in Indonesia. Studies show that the highest potential for Non-Performing Financing (NPF) is associated with PLS contracts, suggesting an elevated risk profile for this financing model in the microfinance sector (Fianto et al., 2019). These insights underline the ongoing tension between the ethical appeal and the practical risks of PLS financing in real-world applications.

Additionally, it is important to note that while Profit-Loss Sharing (PLS) financing may be associated with a higher risk of Non-Performing Financing (NPF), it remains fundamentally aligned with the ethical and equitable principles of Islamic banking. This makes it an essential component of the Islamic finance system, supporting financial inclusion and promoting social welfare. Balancing these inherent benefits with the accompanying risks continues to be a persistent challenge for the industry. Nugraheni & Alimin (2022) found that effective filtering of financing proposals and thorough financial analysis can positively influence the performance of PLS. Their findings suggest that while employees in Islamic banks may have adequate knowledge of PLS structures, credit risk remains a critical issue. Consequently, continuous improvements in customer screening processes are necessary to better manage and mitigate credit risks. Strengthening these mechanisms is vital to ensuring the financial system's stability and integrity. Empirical studies also reveal a difference in credit risk levels between conventional rural banks (BPR) and Sharia-based rural banks (BPRS) in Indonesia. Notably, the NPF value in BPRS tends to be higher than the Non-Performing Loan (NPL) value in BPR. This disparity is partly attributed to the application—or lack thereof—of PLS-based financing in BPRS, highlighting the influence of financing models on credit risk profiles (Wasiaturrahma et al., 2020). Interestingly, even within BPRS, although PLS schemes are more widely available, many small and medium-sized enterprises (SMEs) continue to prefer non-PLS financing instruments due to their perceived lower complexity and risk. This preference suggests that practical considerations, such as predictability and risk exposure, continue to shape SMEs' financing choices (Imronudin & Hussain, 2016).

On the other hand, the relationship between Profit-Loss Sharing (PLS) financing and conventional interest rates remains a subject of concern. Research has shown that profit-sharing rates often appear side by side with prevailing interest rates, undermining the theoretical distinction between Islamic and conventional financial systems (Yusof et al., 2015). Ercan et al., (2021) further observed that investor hesitation toward PLS products often stems from the perceived correlation between profit-sharing returns and interest-based benchmarks. This linkage contradicts the foundational principles of Islamic banking, which strictly prohibit *riba* (usury/interest), and has invited criticism from scholars who question the authenticity of its implementation. Despite this, Islamic banking continues to gain public trust and expansion in various countries (Hassan, 2020).

This persistent gap between theoretical ideals and empirical realities motivates the present study. In particular, the research seeks to explore how PLS financing has been implemented in Islamic banks over the past two decades, what practical challenges have limited its broader application, and which future research directions could strengthen and expand its role within Islamic financial systems. Through a systematic literature review, the study aims to synthesize fragmented global evidence and offer actionable insights to support the more effective and authentic implementation of PLS financing mechanisms.

Literature Review

Development of Global Islamic Banking

The theoretical foundation of modern Islamic banking was first introduced in the 1940s, with a profit-sharing system proposed as an alternative to interest-based finance (OJK, 2017). Early conceptualizations were articulated by Pakistani scholars such as Abul A'la Al-Mawdudi (1961) and Muhammad Hamidullah (1944–1962), who pioneered the idea of interest-free banking—initially aimed at managing Hajj funds. Although this initial attempt was not successful, it laid the groundwork for future developments.

Islamic banking gained international recognition in 1963 with the establishment of Mit Ghamr Savings Bank in Egypt (Chong & Liu, 2009). The bank's success demonstrated that Islamic principles could be applied in modern financial systems, inspiring broader adoption. At the 1970 Conference of Foreign Ministers of the Organization of the Islamic Conference (OIC), Egypt proposed establishing an International Islamic Bank for Trade and Development and a Federation of Islamic Banks. The core idea was to replace interest-based systems with cooperative financing based on a Profit-Loss Sharing (PLS) model. This initiative led to the creation of the Islamic Development Bank (IDB) in 1975, initially involving twenty-two member countries. The IDB has since provided financial support, promoted Islamic economic education, and facilitated the establishment of Islamic banks worldwide.

The same year witnessed the launch of Dubai Islamic Bank—the first private Islamic bank—followed by the establishment of Kuwait Finance House, Kuwait's first Islamic financial institution (Kitamura, 2020). In the 1980s, Islamic banking expanded into other Muslim-majority countries, including Bangladesh, Malaysia, Indonesia, and Pakistan. In Indonesia, discussions around Islamic banking emerged in 1980, with Bank Indonesia (BI) issuing a regulation in 1983 that enabled banks to adopt interest-free models and encouraged the adoption of PLS-based financing. In the same year, Malaysia passed the Islamic Banking Act and established Bank Islam Malaysia Berhad (BIMB), the country's first Islamic bank (Chong & Liu, 2009). Bangladesh followed suit with the creation of Islamic Bank Bangladesh Limited (IBBL) in 1983.

The global presence of Islamic banks has grown substantially since 2000. In Bangladesh, conventional banks such as Export-Import Bank of Bangladesh Limited (EXIM) and First Security Islamic Bank Limited (FSIB) converted to full-fledged

Islamic banks in 2004 and 2008, respectively, although they later experienced fluctuations in performance (Suzuki, 2020). By 2013, 24 of Bangladesh's 56 scheduled banks operated on Islamic principles. In Indonesia, the issuance of the Islamic Banking Act on July 16, 2008 marked a major regulatory milestone. In 2013, the supervision of Islamic banking transitioned from Bank Indonesia to the Financial Services Authority (OJK). By 2023, Indonesia had 13 Islamic Commercial Banks, 20 Islamic Business Units, and 171 Islamic Rural Banks, with a year-on-year asset growth rate of 7.27% (Kemenkeu, 2023). Indonesia ranks third globally in the Islamic Finance Index (IFI), following Malaysia and Saudi Arabia. Malaysia, which operates Islamic and conventional systems in parallel, leads the global Islamic banking sector with an IFI score of 1113.

Profit-Loss Sharing Financing in Islamic Banking

Islamic law regulates permissible *(halal)* and impermissible *(haram)* economic activities. Unlike conventional banking, which is built on interest *(riba)*, Islamic banking adopts a Profit-Loss Sharing (PLS) model wherein investors and borrowers share profits and bear risks collectively. This system is the cornerstone of Islamic finance, ensuring compliance with Shariah law (Khan, 1986).

The PLS model adheres to three fundamental prohibitions: *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling). *Riba*, commonly applied in conventional loans, is strictly forbidden because it is viewed as exploitative and unjust (Molyneux, 2006). *Gharar* is prohibited to ensure transparency and fairness in transactions, requiring full disclosure and mutual consent. *Maysir,* or gambling, is also forbidden; however, business risks shared between investors and entrepreneurs are considered permissible, unlike the risk structures found in insurance contracts, which some scholars equate with gambling.

Within the PLS framework, two primary contract types are used: mudharabah and musyarakah. In mudharabah, the bank acts as a capital provider *(rabb al-mal)*, while the customer serves as the entrepreneur *(mudharib).* Profits are shared according to pre-agreed ratios, but losses are borne solely by the bank unless they result from the entrepreneur's negligence. This structure entails higher risk for the bank due to limited control and exposure to asymmetric information, which may lead to conflicts of interest. In contrast, musyarakah involves joint capital contribution from both the bank and the customer. Profits and losses are shared based on a mutually agreed ratio. This model offers more equitable risk distribution and shared governance compared to mudharabah.

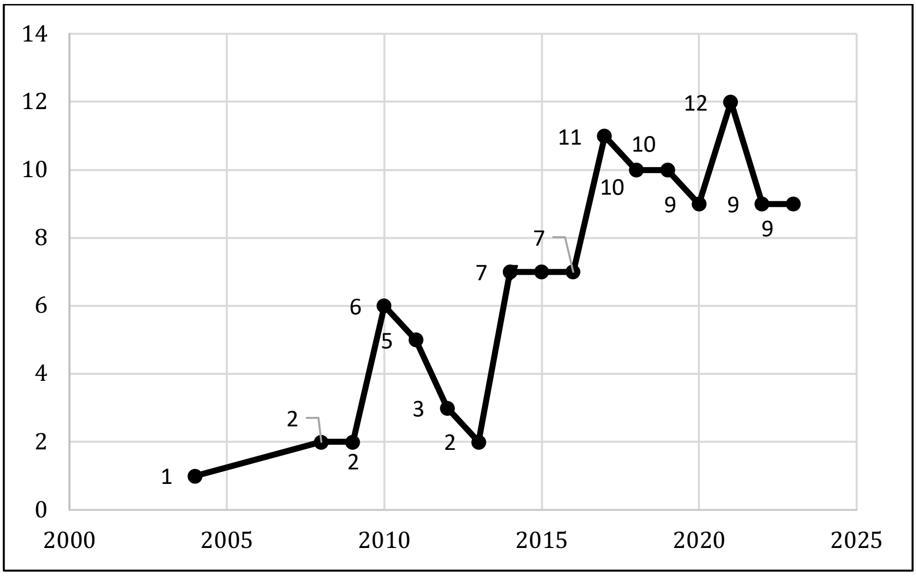
While mudharabah and musyarakah represent core PLS products, Islamic banks also offer contracts such as *murabahah* (cost-plus), *ijarah* (leasing), *bai' muajjal* (deferred payment), *bai' salam* (forward sale), and *istisna'* (manufacturing contract) (Chong & Liu, 2009). Although permitted under Shariah, these contracts often resemble conventional financing mechanisms and have been subject to scholarly debate.

Methods

This study employs the Systematic Literature Review (SLR) method, which supports evidence-based decision-making by systematically narrowing a broad body of literature into a focused set of relevant studies (Ansari, 2022). The SLR approach has been widely adopted in economics and finance research to synthesize knowledge and identify trends across large volumes of academic work. For instance, Javier and Aracil (2021) utilized the SLR method to examine the evolution of sustainable banking literature from 1995 to 2019, refining an initial pool of 2,281 documents down to 676 articles using 1,661 different keywords. Similarly, Nomran (2020) applied the SLR approach to analyze the empirical relationship between Shariah Supervisory Boards (SSBs) and the performance of Islamic banks using articles indexed in Scopus. A more advanced application was conducted by Adhariani (2021), who combined bibliometric, qualitative, and quantitative analyses to examine auditor–client relationships over a 44-year span, using 140 articles from 47 Web of Science–indexed journals.

Building on these methodologies, the present research adopts the SLR method to explore the conceptual development, practical challenges, proposed solutions, and future research directions related to Profit-Loss Sharing (PLS) in Islamic banking. The goal is to generate an integrative understanding of global evidence surrounding PLS financing mechanisms. Data collection was carried out using Publish or Perish 8 (PoP) software to retrieve relevant articles from Scopus-indexed journals. The search strategy used the keywords "profit" AND "loss" AND "sharing", along with "Islamic" AND "banking", focusing on publications from 2003 to 2023. This process yielded a total of 136 documents, including 111 journal articles, one book, 11 book chapters, seven conference papers, and six other types of documents. The trend analysis, as shown in Figure 1, indicates a growing scholarly interest in the theme of Profit-Loss Sharing and Islamic banking over the past two decades, confirming its continued relevance for ongoing academic inquiry.

Figure 1. Number of Profit-Loss Sharing Publication between 2003-2023



These documents will be in the screening process to produce appropriate and qualified article data to answer the five research questions above. In the screening process, documents are selected based on criteria's & and qualities as show at table 1:

Table 1. Criteria and Quality Manuscript

Document Type	**Journal Article**
Total Citation / Year	More than or equal to 1.8 (justification is based on the average number of citations per year across 111 articles)
Article Contents	Relevant to the theme, contains discussion related to Profit-Loss Sharing in Islamic Banking

Figure 2. Data Selection Prism

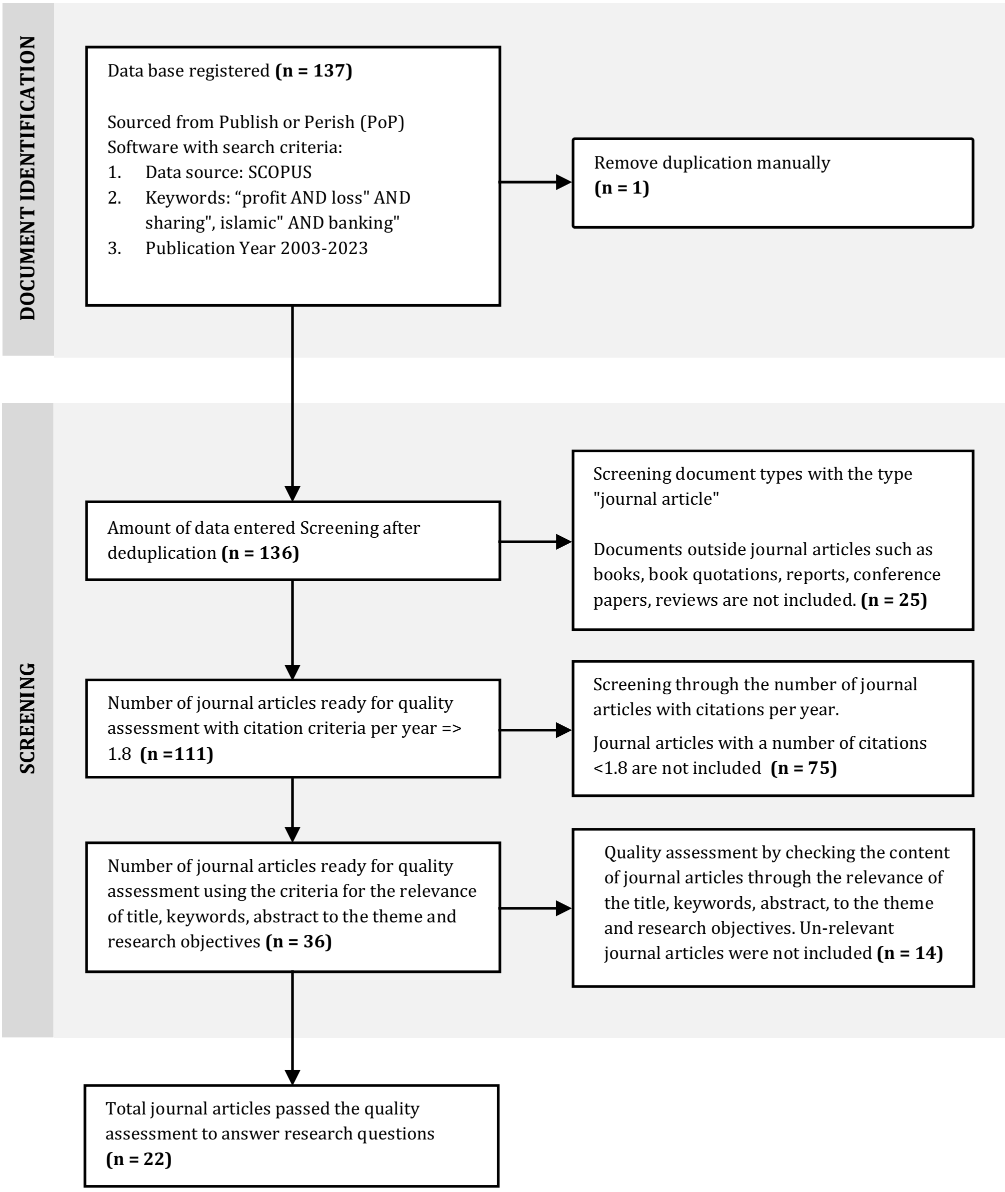


Figure 3. Number of Selected Publications Based on Research Focus

The initial phase of the literature-based data analysis involves classifying journal articles that have passed the quality assessment to identify the research focus. The authors justify this classification based on the articles' titles, abstracts, keywords, and conclusions. Five research focus areas were identified: Review of PLS Constraints, market and customer, regulation and supervision, management and strategy, and macroeconomics and social factors.

During the synthesis process, all selected journal articles will be thoroughly examined to distill core concepts, identify prevailing challenges, and suggest avenues for future research on profit-and-loss sharing in Islamic banking. This involves a detailed examination of the journal articles' content (figure 2).

Result and Discussions

Based on twenty-two Scopus-indexed journal articles retrieved using the Publish or Perish (PoP) software, the researchers organized the analysis into five thematic areas reflecting the identified research foci. The first theme explores the development of the profit-and-loss sharing (PLS) literature within the context of Islamic banking, reinforcing previous findings that highlight the theoretical appeal of PLS contracts like *mudarabah* and *musharakah* and their underutilization due to systemic and institutional constraints. This theme supports and strengthens earlier analyses by showing that limited adoption is a persistent concern echoed across academic literature.

The remaining themes examine the relationship between PLS and Islamic banking from various perspectives, including management and strategic practices, regulatory and supervisory issues, market conditions and customer perceptions, as well as macroeconomic and social factors that influence the implementation of PLS-based financing.

Review of Profit-Loss Sharing Constraints

The literature on profit-loss sharing (PLS) in Islamic finance consistently underscores the gap between theory and practice. Abdul-Rahman et al. (2014) argue that although PLS contracts such as *mudarabah* and *musharakah* are foundational to Islamic finance, their practical application remains marginal due to entrenched systemic barriers. These barriers span four levels of the New Institutional Economics (NIE) framework: socio-cultural norms favoring predictability, legal structures that disadvantage profit-based contracts, weak governance mechanisms, and agency problems like information asymmetry and depositor risk aversion. The authors advocate for a paradigm shift wherein Islamic banks evolve from financial intermediaries into active entrepreneurs, capable of risk-taking and value creation. Institutional reforms, such as better dispute resolution, tax realignment, and enhanced stakeholder accountability, are deemed critical to unlocking the ethical and economic potential of PLS frameworks grounded in the concept of *al-falah* (Abdul-Rahman et al., 2014).

Complementing this structural analysis, Abedifar et al. (2015) provide an empirical overview of Islamic banking performance, highlighting how the dominance of non-PLS instruments like *murabaha*—favored for their lower risk and simplicity—has diluted the risk-sharing ideals of Islamic finance. Their review shows that while Islamic banks demonstrate higher credit quality and crisis resilience, they often lack operational efficiency and face governance and regulatory deficiencies that hinder PLS adoption. The authors call for future research into customer behavior, institutional heterogeneity, and legal-cultural dynamics to better understand the constraints and potential of Shariah-compliant profit-sharing models. Together, both works reveal a coherent narrative: the underutilization of PLS in Islamic finance is rooted in both systemic institutional constraints and pragmatic banking preferences, necessitating comprehensive theoretical and empirical strategies for reform.

Table 2. Sub-theme: Review of Profit-Loss Sharing Constraints

Authors / Year	Publication Title	Methodology	Findings	Journal Name	Citations / Year
A. Abdul-Rahman (2014)	Failure and potential of profit-loss sharing contracts: A perspective of New Institutional, Economic (NIE) Theory	Qualitative	PLS contracts face low adoption due to cultural norms, legal constraints, weak governance, and information asymmetry. Institutional reforms and a transition from intermediary to entrepreneurial banking are essential to realize the full potential of Shariah-compliant profit-sharing models	Pacific Basin Finance Journal	6.22
P. Abedifar (2015)	Islamic banking and finance: Recent empirical literature and directions for future research	Qualitative	Islamic banks are as efficient as conventional ones, often with lower insolvency risk and better performance for small business lending. Islamic funds match or outperform benchmarks, aiding financial inclusion and development. Research gaps remain in governance, systemic risk, Shariah screening, energy-linked performance, and socio-economic impacts, calling for broader interdisciplinary exploration.	Journal of Economic Surveys	12.88
Total Citation / Year					**19.10**

Management & Strategic Practices

Current economic conditions support the growth of both conventional and Islamic banking. However, several internal aspects of bank management and strategy in the Islamic banking sector require further investigation. One key issue concerns the alignment of Islamic banking financing with the principles of Islamic law. In theory, Islamic bank financing is based on the prohibition of interest *(riba)* and promotes profit-sharing mechanisms, commonly known as profit-and-loss sharing (PLS). In practice, however, non-PLS products such as *Murabahah* and *Ijarah* continue to dominate Islamic financing schemes. PLS-based products, which constitute the core of Islamic banking principles, remain a minor component. To remain competitive, Islamic banks often replicate conventional banking practices.

For instance, in Malaysia, the application of PLS financing accounts for only about 0.5% of deposit-side assets (Chong & Liu, 2009). Similar findings have been reported in GCC countries, where the implementation of PLS-based financing remains limited. This underutilization persists despite evidence that PLS models may reduce the incidence of non-performing loans (Alandejani & Asutay, 2017), although such schemes are often concentrated in high-risk sectors such as construction.

Another key issue is the credit risk dilemma in implementing PLS financing. Faced with market competition, two Bangladeshi banks—EXIM and FSIB—converted to Islamic banking in 2004 and 2008, respectively. While the conversion helped reduce FSIB's non-performing loan (NPL) ratio between 2008 and 2012, EXIM experienced a doubling of its NPL rate in 2012–2013, which coincided with the introduction of equity-based financing and led to a decline in return on assets (ROA). As Suzuki (2020) notes, the conversion strategy made the credit portfolios of both banks more vulnerable and unstable.

Table 3. Sub-theme: Management & Strategy

Authors / Year	Publication Title	Methodology	Findings	Journal Name	Citations / Year
B. Chong (2009)	Islamic banking: Interest-free or interest-based?	Quantitative	Percentage financing at Islamic banks in Malaysia and various Islamic countries Still dominated by practice similar financing _ to conventional	Pacific Basin Finance Journal	33.21
M. Alandejani (2017)	Nonperforming loans in the GCC banking sector: Does the Islamic finance matter?	Quantitative	The level of construction real estate financing, causes its height NPL levels in the GCC. PLS & GDP growth capable give effect negative for NPL however impact small Because low level PLS financing	Research in International Business and Finance	6.33
Y. Suzuki (2020)	Incentives for conventional banks for the conversion into Islamic banks: evidence from Bangladesh	Quantitative	Conversion Bank and FSIB Bangladesh concentrate to financing based assets, Percentage Equity mode financing is very small.	Journal of Islamic Accounting and Business Research	2.00
Total Citation / Year					**41.54**

These cases highlight the untapped potential of improving the PLS financing system. Diversification of Islamic financing instruments, strategic management to address competitive pressures, and robust regulatory oversight are critical tools for strengthening Islamic banking. Such measures can enhance the competitiveness of Islamic financial institutions while ensuring compliance with Sharia principles.

Regulation and Supervision of PLS Financing Implementation

Building on earlier discussions about challenges in implementing profit-and-loss sharing (PLS) within Islamic banking—particularly practices that deviate from interest-free principles—this section further explores findings related to regulation and supervisory mechanisms in the sector. Among the four journal articles reviewed under this sub-theme, three identified a recurring issue: conflict of interest. This challenge is closely tied to the effectiveness of Sharia Supervisory Boards (SSBs), governance rights of depositors, information asymmetry, and overall performance transparency in Islamic banking operations.

A study of 88 Islamic banks across 16 countries from 2007 to 2014 found that the effectiveness of the Sharia Supervisory Board plays a pivotal role in the selection of equity-based financing (Meslier et al., 2020). When SSBs lack independence—particularly when members are appointed by the board of directors—conflicts of interest may arise. This can lead to a preference for non-PLS financing, which is perceived as lower risk compared to PLS contracts, thereby undermining the spirit of Islamic finance. Consequently, regulatory frameworks should strengthen oversight of PLS financing while encouraging the integration of SSBs into executive decision-making structures, ensuring they serve not only as monitors but also as active participants in strategic governance.

Conflict of interest also extends to profit management in non-PLS (NPLS) contracts. In Malaysia, research indicates that when Islamic bank ownership is highly concentrated among trading families or government entities, there is significant potential for earnings manipulation in NPLS products (Zainuldin, 2020). This reinforces the need for robust central bank oversight of financial products offered by Islamic banks. Furthermore, improved governance mechanisms are necessary to protect the rights of unrestricted investment account holders (UIAH) and to promote transparency in profit allocation. Archer et al. (2017) highlight that, in the GCC context, discrepancies between returns for shareholders and UIAH account holders stem largely from inadequate information disclosure and ethical concerns related to profit-sharing.

Another key regulatory insight comes from Pakistan, where a lack of standardized training, institutional capacity, and human resources limits effective Islamic banking implementation. Majeed (2017) argues that regulators should promote awareness and establish coordination with educational institutions to build foundational knowledge of Sharia-compliant financial practices. The study's empirical findings, based on regional surveys, underscore the critical role of well-informed SSBs and financial literacy in enabling Islamic banks to contribute meaningfully to socio-economic objectives, such as poverty alleviation.

Table 4. Sub-theme: Regulation & Supervision

Authors (year)	Title Publication	Methodology	Findings	Journal Name	Citations/ Year
C. Meslier (2020)	Islamic banks' equity financing, Shariah supervisory boards, and banking environments	Quantitative	The Sharia Supervisory Board still needs to be independently established, potentially leading to conflicts of interest in selecting NPLS business.	Pacific Basin Finance Journal	8.33
MT Majeed (2017)	How Islamic is Islamic banking in Pakistan?	Qualitative	Islamic banks follow Islamic law regulations but exclude PLS and qard-ul-hassan provisions. Customers disagree about Sharia-based operations in Islamic banks.	Pacific Basin Finance Journal	4.67
MH Zainuldin (2020)	Earnings management in financial institutions: A comparative study of Islamic banks and conventional banks in emerging markets	Quantitative	Islamic banks conduct higher earnings management practices than conventional banks, especially during economic crises, to avoid losses. Regulation of banking activities and supervision of officials have a significant relationship with the practice of Islamic banks.	Pacific Basin Finance Journal	4.67
S. Alhammadi (2018)	Perspective of corporate governance and ethical issues with profit sharing investment accounts in Islamic banks	Quantitative	UIAH Account Holders have no governance rights and are vulnerable to conflicts of interest due to lack of information transparency	Journal of Financial Regulation and Compliance	2.00
Total Citation / Year					**17.67**

Market Conditions and Customer Perceptions

As highlighted in the previous section, the adoption of profit-and-loss sharing (PLS) financing in Islamic banking remains relatively low compared to non-PLS instruments. In addition to interbank competition and internal management factors, public awareness, interest, and understanding of Islamic financial principles significantly influence the utilization of PLS-based products. Eight of the twenty-two journal articles reviewed—accounting for over 36%—focus on this sub-theme, with an average annual citation rate of 48.45, underscoring its relevance in contemporary Islamic banking discourse.

One important consideration is the growing Muslim population, which presents both an opportunity and a challenge for Islamic banking. A critical issue is whether customer religiosity influences loyalty to Sharia-compliant financing, or whether preferences are driven more by material or economic incentives. A survey of 658 Islamic banking customers in Indonesia found that religiosity significantly affects customer commitment to Islamic banking products (Junaidi, 2022b). However, previous research also found that Islamic banks tend to maintain higher liquidity buffers, suggesting that while religious motivation attracts depositors, other operational concerns may still dominate banking practices (AlAbbad et al., 2021). These findings imply the need for enhanced promotional strategies that align with Sharia principles and educate customers about what is *halal* (permissible) or *haram* (prohibited). They also offer valuable insights for investors evaluating Islamic financial products and for regulators and Sharia supervisory boards in ensuring compliance with Islamic law.

Understanding public perceptions of the benefits, risks, and dilemmas associated with PLS financing is also essential. In a competitive financial environment, Islamic banks must retain and expand their customer base. The high-risk nature of PLS contracts often deters both banks and customers, prompting preference for more secure, non-PLS options. However, evidence suggests that informed customers are more open to engaging with equity-based products. A survey in Malaysia demonstrated that detailed information on the principles and operations of PLS financing increased interest even among non-Muslim respondents (Hoque et al., 2019). Similarly, in Indonesia, awareness of Sharia-compliant financing has been linked to the growth of equity-based financing for small and medium enterprises, despite ongoing concerns about leasing mechanisms and credit risk due to asymmetric information (Suzuki et al., 2019). Nonetheless, persistent issues such as lack of public trust, unfavorable perceptions, and regulatory ambiguity continue to hinder the broader adoption of PLS practices. In the UK, for example, these challenges have contributed to declining public confidence in Islamic banking (Akbar et al., 2012). This underscores the need for marketing teams within Islamic banks to innovate in communicating product value and building trust within diverse communities.

Finally, both Islamic banks and regulators must strengthen consumer education regarding the fundamental characteristics, principles, and benefits of Islamic banking. A study involving 304 respondents in Nigeria revealed that gaps in understanding led many potential customers to delay opening Islamic banking accounts (Ringim, 2013). In Ghana, Muslim respondents expressed positive perceptions about Islamic finance's potential to enhance economic welfare, while non-Muslims remained skeptical about the motivations and advantages of PLS financing (Mbawuni, 2018). These findings indicate that enhanced financial literacy—grounded in Sharia principles—can promote the adoption of PLS systems without necessitating consumer protection mechanisms that are inconsistent with Islamic jurisprudence. Bitar & Tarazi (2019) emphasize that, with sufficient customer awareness and education, PLS financing can be implemented effectively and ethically, contributing to the credibility and sustainability of Islamic banking.

Table 5. Sub-theme: Market Conditions & Customer Perceptions

Authors / Year	Title Publication	Methodology	Findings	Journal Name	Citations/ Year
J. Junaidi (2012)	Religiosity versus profit-loss sharing: how Islamic banks brand fidelity influences the Muslim consumers' commitment	Qualitative	The level of religiosity of a consumer influences the consumer's commitment to choose product banking Islam.	Journal of Islamic Accounting and Business Research	15.00
J. Mbawuni (2018)	Muslim and non-Muslim consumers' perception towards introduction of Islamic banking in Ghana	Qualitative	Perception is positive from respondents Muslim to Islamic banking, but non-Muslim respondents still need more knowledge about Islamic banking. Needed relevance aspect innovation for increased adoption of Islamic banking in Ghana	Journal of Islamic Accounting and Business Research	2.00

Authors / Year	Title Publication	Methodology	Findings	Journal Name	Citations/ Year
KJ Ringim (2013)	Understanding of account holders in conventional banks toward Islamic banking products	Qualitative	Importance of education improvement and knowledge society to characteristics and benefits of Islamic banks	Middle East Journal of Scientific Research	11.9
M. Bitar (2019)	Creditor rights and bank capital decisions: Conventional vs. Islamic banking	Quantitative	Protective role consumer No relevant to Islamic banking context, application PLS principles are based on sharia law in the majority of countries Muslims. However, in countries with a majority of resident non-Muslims, protection consumers related tightly to Islamic banks.	Journal of Corporate Finance	7.25
M.E. Hoque (2019)	Factors influencing Islamic banking behavioral intention: the moderating effects of customer marketing practices and financial considerations	Qualitative	Many factors like attitudes and interests of customers, customer relationships with banks, benefits of potential financing, and information method Work PLS financing have an impact on significant PLS financing. In contrast, financial risk has a negative impact.	Journal of Financial Services Marketing	4.25
S. Akbar (2012)	An investigation of user perceptions of Islamic banking practices in the United Kingdom	Qualitative	Complexity Islamic banking makes public English No Certain benefit of PLS and hopes commitment and role of Islamic banks in prosperous public.	International Journal of Islamic and Middle Eastern Finance and Management	3.55
Y. Suzuki (2019)	Do Islamic banks need to earn extra profits? A comparative analysis on banking sector rent in Bangladesh and Indonesia	Quantitative	Support regulation, innovation, and encouragement division of SMEs in Indonesia make development financing-based equity tall compared to Bangladesh. Opportunity financing rent in Bangladesh is high. However, regulation and supervision of the practice portfolio are still required.	Journal of Islamic Accounting and Business Research	2.50

Authors / Year	Title Publication	Methodology	Findings	Journal Name	Citations/ Year
A. AlAbbad (2021)	Depositor Characteristics and the Performance of Islamic Banks	Quantitative	Religious, political, socio-legal, and regulatory support play a role in attracting depositors to Islamic banks. Islamic banks have higher liquidity buffer as a provision for risk.	Journal of Accounting, Auditing and Finance	2.00
Total Citation / Year					**46.45**

Macroeconomic and Social Factors

The application of profit-and-loss sharing (PLS) in Islamic banking is deeply intertwined with macroeconomic determinants and regional economic conditions. Factors such as national development levels, strategic financial management, profitability trends, and market dynamics all influence how PLS systems operate. The foundational relationship between macroeconomic variables and banking performance was first recognized by Revell (1979), who highlighted the link between inflation and rising banking costs. More recent studies of African Islamic banks reveal that these institutions often anticipate inflationary changes to mitigate credit risk, thereby fostering more stable and profitable operating conditions. Furthermore, economic growth, measured by fluctuations in GDP, has been shown to positively influence the expansion of Islamic banking (Karim et al., 2010). In response, African Islamic banks are encouraged to bolster equity reserves and enhance loan efficiency to reduce the risk of insolvency.

In the Middle East and North Africa (MENA) region, research involving 50 Islamic banks and 14 Sharia-compliant financial institutions demonstrates that periods of economic expansion can influence bank margins as part of broader risk management strategies. However, these findings also highlight the need for alignment between such financial practices and the ethical and developmental goals of Islamic banking (Bougatef, 2018). Notably, the role of religiosity has emerged as a protective factor in times of economic uncertainty. A cross-country study covering 568 Islamic and conventional banks in 20 countries from 2009 to 2018 found that in societies with high levels of religiosity, Islamic banks were less vulnerable to default risk during periods of economic instability. In contrast, conventional banks in countries with higher PLS adoption rates were more adversely affected (Bilgin et al., 2021). These insights underscore the importance of policy interventions—such as recapitalizing conventional banks—to offset the leverage effects of economic shocks, while also offering a valuable direction for future research on the intersection of religiosity, macroeconomic volatility, and Islamic banking performance.

Table 6. Sub-theme: Macroeconomic & Social Factors

Authors/ Year	Title Publication	Methodology	Findings	Journal Name	Citation/ Year
BK Karim (2010)	Bank-specific, industry-specific and macroeconomic determinants of African Islamic banks' profitability	Quantitative	Capital, bank size, and macro economy can increase profitability. Risk credit and efficiency operation lower profitability. More bank growth can cause low profitability	International Journal of Business and Management Science	2.08
K. Bougate (2018)	The determinants of intermediation margins in Islamic and conventional banks	Quantitative	The level of risk aversion and diversification is a determinant of intermediation in Islamic banking	ISRA International Journal of Islamic Finance	2.40
K. Bougatef (2020)	The nexus between Islamic banking and industrial production: Empirical evidence from Malaysia	Quantitative	PLS financing does not impact positive the development industry, whereas NPLS financing has a significant impact	ISRA International Journal of Islamic Finance	4.33
M. Zulkhibri (2018)	The impact of monetary policy on Islamic bank financing: bank-level evidence from Malaysia	Quantitative	Islamic banks have a positive impact on entrepreneurial motivation, competitiveness, and performance of SMEs	Journal of Economics, Finance and Administrative Science	2.80
MH Bilgin (2021)	Economic uncertainty and bank stability: Conventional vs. Islamic banking	Quantitative	Economic fluctuations do not increase the failure of Islamic banks with the PLS system and a good level of religious societies such as Indonesia, Iran, and Bangladesh.	Journal of Financial Stability	15.50
Total Quotes / Year					**27.10**

From a developmental perspective, Islamic banking is inherently intended to promote societal welfare. The rise of small and medium-sized enterprises (SMEs) and industrial sectors represents both an opportunity and a responsibility for Islamic banks to contribute meaningfully through PLS-based financing. However, empirical research directly linking SME growth to PLS utilization remains scarce. Studies in Malaysia indicate that the share of PLS financing remains low and that Islamic bank responses to interest rate changes still mirror those of conventional banks (Zulkhibri, 2018). Supporting this, (Bougatef et al., 2020) found that, despite its theoretical centrality, PLS financing does not significantly stimulate production growth—largely due to its limited volume. Conversely, increases in production have been linked to growth in non-PLS financing, which often entails lower risk and quicker capital deployment.

One major challenge facing PLS financing is the inherent time lag between fund collection and disbursement in *mudharabah* and *musyarakah* arrangements. This lag necessitates strong, long-term relationships between Islamic banks and investment partners, which can be difficult to sustain without institutional support. Given the persistently low proportion of PLS financing in Malaysia, regulatory bodies are expected to intensify their efforts to expand the Islamic banking sector and support equity-based financial solutions that align with Sharia principles.

Challenges of Implementing Profit-Loss Sharing (PLS)

This study re-examines the implementation challenges and outlines potential directions for further research related to profit-and-loss sharing (PLS) in Islamic banking. Drawing from the findings discussed in previous sections, several key challenges emerge that continue to constrain the effective application of PLS-based financing models.

Purity of Islamic Banking Practices

One of the fundamental challenges lies in the perceived dilution of Islamic banking's foundational principles. Theoretically, Islamic banking is distinguished by its adherence to interest-free (riba-free) financing, with PLS mechanisms such as *mudharabah* and *musyarakah* representing its core financial instruments. Given the significant growth in small and medium-sized enterprises (SMEs) and industrial production, there is a clear opportunity for Islamic banks to increase the share of PLS financing. However, in practice, PLS remains underutilized.

Facing intense competition, credit risk exposure, and the complexities associated with SME financing, Islamic banks often rely on non-PLS (NPLS) instruments—many of which mirror conventional banking products and are closely tied to interest-based pricing. This reality fosters customer skepticism regarding the authenticity of Islamic banking operations and provokes ongoing scholarly debates over the extent to which current practices align with Sharia principles. These concerns highlight the need for stronger regulatory oversight of Islamic financial products and greater innovation from bank management in diversifying offerings and enhancing market communication of PLS practices.

Credit Risk in PLS Financing

Another substantial barrier is the inherent credit risk in PLS contracts. Financing arrangements based on *mudharabah* and *musyarakah* involve extended tenures and are particularly vulnerable to agency problems, including asymmetric information and governance imbalances. Investors in these structures typically lack full control over project operations, making them susceptible to leverage risks, earnings manipulation, and potential conflicts of interest.

To address these vulnerabilities, Islamic banks must improve their customer screening processes and adopt robust diversification strategies. Enhancing risk assessment frameworks will be crucial in managing leverage exposure. Furthermore, integrating Sharia Supervisory Board (SSB) members into executive decision-making roles—rather than limiting them to oversight functions—can help align operational strategies with Islamic principles and improve transparency in PLS decision-making.

Customer Understanding and Knowledge

Limited public understanding of PLS concepts is another major impediment to its widespread adoption. While *mudharabah* and *musyarakah* emphasize community welfare and the prohibition of riba, this message often fails to reach the broader public effectively. Many potential customers remain hesitant to engage with PLS financing due to unclear information, unfamiliarity with profit-sharing mechanisms, and misconceptions about associated risks.

Compounding these issues are societal dilemmas such as perceived difficulties in accessing financing, negative political narratives, and lack of financial education. Overcoming these barriers requires coordinated efforts between regulators and Islamic banks to provide clear, accessible education on the principles, benefits, and practicalities of PLS. Internal reforms to enhance service quality and public engagement, along with innovative, informative promotional strategies, can help reshape public perception and encourage greater participation in PLS-based systems.

Community Religious Commitment

The religious commitment of the broader community plays a pivotal role in shaping customer preferences for Islamic financial products. The rising Muslim population in various countries presents an opportunity to expand the reach of PLS financing. Studies indicate that religiosity significantly influences consumer decision-making, particularly in Muslim-majority contexts where PLS principles are guided more by spiritual values than by market-based concerns.

Communities with high levels of religious observance tend to exhibit stronger adherence to Sharia-compliant financial practices. This is reflected in their careful attention to distinguishing between *halal* and *haram* financial products. Empirical evidence further suggests that in such religious societies, Islamic banks face lower default risks during times of economic uncertainty, whereas conventional banks often experience greater instability. This dynamic underscores the importance of religious orientation in determining both individual financial behavior and broader systemic resilience in Islamic banking.

Conclusion

The study finds that the implementation of profit-and-loss sharing (PLS) in Islamic banking remains only partially aligned with Shariah principles and is hindered by inadequate supervision, credit risks, and moral hazard concerns. It also identifies a pressing need for innovation in financing instruments, increased public understanding of PLS mechanisms, and strengthened operational management to improve profitability and customer trust. The analysis sheds light on the practical tensions between the theoretical ideals of Islamic finance and the market-driven realities Islamic banks face. Aligning PLS practices more closely with Shariah values will require coordinated efforts involving regulatory reform, strategic product development, and enhanced public engagement. These findings offer clear implications for policymakers and practitioners aiming to improve the long-term effectiveness, resilience, and competitiveness of Islamic banking systems.

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