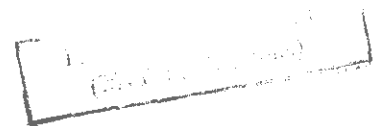
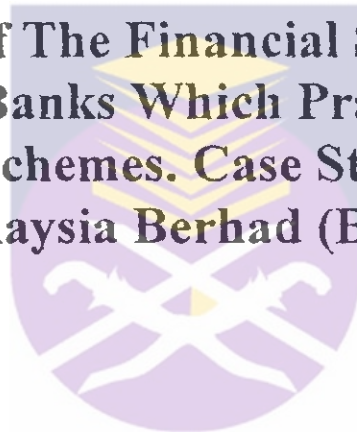


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**Final Research Report
On**

**Determinations Of The Financial Strategy
Of Malaysian Banks Which Practise
Interest Free Schemes. Case Study:
Bank Islam Malaysia Berhad (BIMB)**



**Presented to,
Research and Consultancy Centre
Institut Teknologi Mara
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**DETERMINANTS OF THE FINANCIAL STRATEGY OF
MALAYSIAN BANKS WHICH PRACTISE INTEREST FREE
SCHEMES. CASE STUDY BANK ISLAM MALAYSIA
BERHAD (BIMB).**

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Abstract

This study examines the importance of Islamic banks in Malaysia as an institution which offers interest-free scheme. The study revealed that there are interactions between environmental determinants and financial strategies of Bank Islam Malaysia Berhad (BIMB). The model proved that before the adoption of the interest-free scheme by conventional banks in Malaysia, BIMB enjoyed high strategic choice and low environmental determinism. However, at the early stage of the adoption of interest-free scheme, BIMB faced high environmental determinism and low strategic choice. When all the conventional banks in Malaysia adopted interest-free scheme as one of their products, BIMB faced high environmental determinism and high strategic choice.

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1.0 INTRODUCTION

The concept of Islamic Banking on the basis of profit sharing was initially developed under the explicit assumption of a general prohibition of interest - which was widely accepted as one form of 'riba' and strictly prohibited in Islam.

Islamic financial institution in Malaysia started in the 1980s, where some institutions were established with the main objective to cater the banking needs of Muslims wishing to conduct their banking business in accordance with the principles of Shariah. Such institutions are Bank Islam Malaysia Berhad (BIMB), Pilgrims Management and Fund Board or Tabung Haji, Malaysian Islamic Economic Development Foundation (YAPEIM), and Syarikat Takaful Malaysia Sdn. Bhd. (STMSB).

However these institutions are inadequate to cater the financial needs of the majority Muslim population (53 percent of the total population) according to the dictates of Islam.

Actions have to be taken for Islamisation of the conventional financial institutions, upgrading of the existing Islamic institutions and establishment of new Islamic financial institutions are necessary due to the prohibition of riba (interest). The conventional system may not be acceptable for long amongst the Malaysian Muslim due to the distinct Islamic perspective on economic development characterised by

both material development as well as spiritual components. This process of Islamisation has concentrated mainly on establishing Islamic banks that operate in accordance with Islamic law and the need for adequate provisions of Shariah - based financial facilities and services in Malaysia. To achieve this objective, the integration of all the Islamic financial institutions and financial services into an Islamic financial system are required. This financial system should contain a full array of Islamic financial institutions, a wide range of Islamic financial instruments, and viable primary and secondary capital markets for the Islamic instruments and also an interbank money market.

In their mobilization of funds Islamic banks operate on a system based on profit and loss sharing (PLS) in all financial transactions. Thus the basic difference between Islamic banks and conventional banks is that the former operates on an equity-based system in which economic agents are not guaranteed a pre-determined rate of return.

The shift towards the institution of an Islamic banking system has attracted considerable attention on the part of economists in Islamic countries (see Siddiqui, 1981). However many studies had been done to examine the aspect of the structure and operation of the Islamic economy and very few studies had been done to study the financial management of Islamic banks (e.g. Bashier 1983, Tomkins and Karim 1987). As such this paper tries to highlight on the important aspect of Islamic banks that can contribute to both the theory of finance and Islamic banking.

Moreover, this study also tries to investigate the interaction between the environment and financial strategy of Bank Islam Malaysia Berhad (BIMB), in particular, in order to explain the changes in the capital structure. A case study was made on BIMB. The study covers the period 1988-1994 which reflects the period before and after the adoption of interest-free scheme in Malaysian banks.

For the purpose of this study, the paper highlights for the period 1988-1994. As on March 4, 1993, finance Minister Datuk Seri Anwar Ibrahim, launched the interest - free banking scheme in certain banks in Malaysia to open interest-free counters to offer Islamic banking services to their clients. These banks include Bank Bumiputras Malaysia Berhad (BBMB) Maybank and United Malayan Banking Cooperation (UMBC). Accordingly, we shall examine the eras 1993-1994 that is the period of switching from a single Islamic banks to complete network of Islamic banks, within the network of conventional banks.

The paper also tries to explain whether there is an impact of interest-free scheme on Bank Islam (BIMB) and as to how the Bank tries to assess the impact of conventional banks participation in the interest-free scheme on BIMB's deposits, and what strategies undertaken by the Bank about the developing competition.

The first half of the paper gives general background of the Islamic banking system. The second part reviews the organization theory literature on the interaction of environment and strategic choice. In the third section the paper explains the situation

of BIMB before the launching of the interest-free banking scheme, where BIMB is the monopoly. Then, the situation after the adoption of interest-free scheme by all conventional banks in Malaysia. In the fourth section we discuss the research methodology, the details of the case studies and the analysis. The concluding remarks are presented in the last section.

2.0 INTEREST - FREE BANKING SCHEME

2.1 Overview

Interest - free banking scheme was launched on March 4, 1993, by Financial Minister Datuk Seri Anwar Ibrahim. Under this new scheme 3 banks in Malaysia are allowed to offer interest - free counters to their clients. They are Bank Bumiputra Malaysia Berhad (BBMB), Malayan Banking Berhad (Maybank), and United Malayan Banking Corporation (UMBC). Initially, these banks are permitted to collect interest - free deposits under current account, savings account, general investment account and special investment account. These deposits are then used for house financing, car financing, leasing and accepted bills. 15 interest - free products for the commercial banks, finance companies and merchant bank are likely to be approved by Bank Negara Malaysia. All these products are based on the Islamic principles of Al-Wadiah, Yad Dhamanah, Al-Murabahah, Bai'Bithaman Ajil, Al-Mudharabah, Al-

Musharakah, Al-Jur, Al-Ijara Thumma Al-Bai, Baik Al-Dayn, and Al-Kafalah.

Table 1 shows the summary of Islamic Products by Financial Institutions.

Table 1: Summary of Islamic Products by Financial Institutions				
Product	Islamic Principle	Commercial Bank	Financial Company	Merchant Bank
1. Current account	Al-Wadiah	✓	-	-
2. Savings account	Al-Wadiah	✓	✓	-
3. General investment deposit	Al-Mudharabah	✓	✓	✓
4. Special investment deposit	Al-Mudharabah	✓	✓	✓
5. Interest - free house financing	Bai' Bithaman Ajil	✓	✓	-
6. Interest - free car financing	Bai' Bithaman Ajil	✓	✓	-
7. Leasing	Al-Ijarah Thumma Al-Bai'	✓	✓	✓
8. Murabahah financing	Al-Murabahah	✓	✓	✓
9. Mudharabah financing	Al-Mudharabah	✓	✓	✓
10. Musyarakah financing	Al-Musyarakah	✓	✓	✓
11. Bai' Bithaman Ajil financing	Bai' Bithaman Ajil	✓	✓	✓
12. Interest - free export credit refinancing	Al-Mudharabah and Bai' Al-Dayn	✓	-	-
13. Interest - free accepted bills	Al-Mudharabah and Bai' Al-Dayn	✓	-	✓
14.	Al-Ujr	✓	-	✓
15. Shipping guarantee	Al-Kafalah	✓	-	-
16. Bank finance guarantee	Al-Kafalah	✓	✓	✓

Source: Bank Negara Malaysia. June 1, 1993

Since the launching of this scheme on March 4, 1993 by the Minister of Finance, BBMB has out performed other banks. The bank has opened 89 branches with interest - free counters in the states of Selangor, Wilayah Persekutuan, Kelantan, Terengganu and Pahang, in Kucing and Kota Kinabalu in East Malaysia. Table 2 shows the status Report on the interest - free Banking Scheme by the 3 banks i.e. BBMB, Maybank and UMBC between March 27 - May 17, 1993.

Table 2: Status Report on the Interest-free Banking Scheme: March 27-May 17, 1993					
	Savings		Investment		
	No. of a/c holders	Amount	No. of Depositors	Amount	Total
		RM		RM	RM
Malayan Banking 77 No. of branches					
March 27, 1993	626	607,000.00	39	1,430,000.00	2,037,000.00
April 21, 1993	1,281	1,271,000.00	72	1,943,000.00	3,214,000.00
May 17, 1993	1,600	1,909,577.24	105	2,824,626.00	4,734,203.24
Bank Bumiputra No. of branches 63					
March 27, 1993	1,791	2,800,000.00	154	13,800,000.00	16,600,000.00
April 21, 1993	2,396	4,140,158.29	210	16,216,388.00	20,356,546.29
May 17, 1993	3,586	6,264,759.73	303	21,815,428.24	28,080,187.97
UMBC No. of branches 6					
March 27, 1993	111	103,000.00	7	760,000.00	863,000.00
April 21, 1993	176	187,000.00	10	1,788,000.00	1,975,000.00
May 17, 1993	190	209,000.00	12	3,045,000.00	3,254,000.00
Overall No. of branches 146					
March 27, 1993	2,528	3,310,000.00	200	15,990,000.00	19,500,000.00
April 21, 1993	3,853	5,598,158.29	292	19,947,388.00	25,545,546.29
May 17, 1993	5,376	8,383,336.97	420	27,685,054.24	36,068,392.18

Source: Bank Negara Malaysia. June 1, 1993

Beside, the three banks mentioned above, there are other financial companies and banks that have shown interest in the scheme. Namely, the Development and Commercial Bank, MBF Finance, Bank Kerjasama Rakyat, Kwong Yik Bank, Standard Chartered and other commercial banks in Malaysia.

this accounted for a substantial share of the interest-free deposits mobilised by the commercial banks in the country, and also the highest among the commercial banks.

3.0 CASE STUDIES BANK ISLAM MALAYSIA BERHAD (BIMB)

BIMB was incorporated in July 1983. During the last eleven years of its existence, the Bank has successfully worked to lay a firm foundation for its operation as an Islamic commercial bank. The bank has succeeded in its task, under the guidance of its Syariah Supervisory Council, the supervision of Bank Negara Malaysia (Central Bank of Malaysia) and the support of all.

3.1 BIMB Corporate Objective

The Bank is principally engaged in Islamic banking business; like all other Islamic Commercial banks is solely to operate it in line with Syariah or Islamic laws and regulation.

The Jurist have divided Syariah into:-

- Ibadat, or act of worshipping Allah
- Muamalah or laws relating to marriage, divorce, etc.
- Muamalah, or laws relating to commercial transaction, etc.
- Jinayah, or Criminal laws.

The corporate objective of the bank is to provide commercial banking facilities and services which comply with the Islamic Muamalah, rules and regulations to all Muslims and the people of Malaysia.

3.2 Capital Structure of Islamic Bank

Islamic banks have to depend on equity financing not debt financing. This is due to the prohibition of the payment and receipt of interest ('riba') in all financial transaction. No investment or lending transaction that would generate a predetermined rate of return. The capital structure of Islamic banks comprised of shareholders' equity, saving account deposits, current account deposits and investment account deposits.

3.3 Shareholders' Funds

The only source of equity funds is raised through the sale of shares to the public. The shareholders of an Islamic bank have the right to control the management of the bank.

3.4 Saving Deposit

This type of account varies from one Islamic bank to another. Example, BIMB accepts deposit from its customers looking for safe custody of their funds and a degree of convenience. The customers may withdraw a part or the whole of their balances at any time they so desire. The Bank guarantees the refund of such balance. All the profit generated by the Bank from the use of such funds belong to the Bank. Practically, the Bank gives no reward to the holders of Saving Accounts. However, the Bank may at its obsolete discretion reward the customers by returning a portion of the profits generated from the use of their funds from time to time.

3.5 Current Deposit

This type of account is to facilitate transactions and other types of payments. It is a service offered by the banks to its customers. Under this service, the banks usually levy a fee on deposits to cover the costs of administering. Usually depositors do not receive any return on their funds. It is a short-term nature.

The bank accepts deposit from its customers looking for safe custody of their funds. The bank requests permission from such customers to make use of their funds so long as these funds remain with the bank.

3.6 Investment Deposit (Investment Accounts)

This type of investment is similar to saving deposits. However the investment holder is not guaranteed of the rate of return on investment. At present BIMB offer the distribution in the ratio of 70% to the customers and 30% to the Bank. This offer of the ratio of distribution of profits may be varied from time to time. In the case of a loss in the investment the customers bear all the losses. Holders of the investment do not have any control over the management of the bank for the distribution of its earning.

4.0 BANK ISLAM MALAYSIA BERHAD (BIMB)

THE 1993 - 1994 PERIOD

The bank, like many other Islamic Commercial banks, has been organised as a commercial (tijari) entity. Hence operates as a commercial organisation within the confines of muamalah rules and regulations.

Before March 4, 1993, BIMB is the only bank whose entire operations are interest-free in Malaysia. The participation of conventional banks in the scheme would also affect the BIMB in terms of its modes of operations. By contrast, BIMB is the main beneficiary of the interest-free scheme in the short-term as the conventional banks

and finance companies such as Maybank, Bank Rakyat and MFB finance Berhad have engaged BIMB's services on a consultancy basis.

In view of aggressive competition from the big banks, and concerned about the aggressive competition, BIMB has designed a strategy to reach out to Muslim customers who have been left unattended so far, through mini branches. BIMB has obtained Bank Negara's approval to open 27 such branches. Table 4 shows that BIMB has so far not only maintained its deposits, it also showed some improvement since the introduction of the interest free scheme.

Tables 4: Status Report on Bank Islam, March 31 May 8, 1993

	March 31, 1993	April 30, 1993	May 8, 1993
Current Account	361,497.00	379,032.00	395,272.00
Savings Account	315,268.00	316,502.00	309,733.00
General Investment Deposits	569,289.00	569,329.00	565,114.00
Sub-total	1,246,054.00	1,264,863.00	1,270,119.00
Special Investment	165,230.00	175,178.00	186,593.00
Total	1,411,284.00	1440,041.00	1456,712.00

Source: Bank Negara Malaysia

During this period, BIMB was facing very aggressive competition from the big banks, such as Bank Bumiputra Malaysia Berhad, May Bank Berhad and United Malayan Banking Berhad. As such BIMB will not be able to continue with its present profit sharing formula devised in 1983, and would force to concede better returns to its deposit.

Table 5, shows that BIMB experienced rapid growth during this period, inspite of the introduction of interest free scheme in other giant banks in Malaysia. The growth, in these period (1993-1994) occurred both in its available resources and investment operations.

Table 5: The Financial and Investment Profile of Bank Islam Malaysia Berhad (BIMB): 1993-1994 (In Millions RM)

	1994	1993
Capital: Authorized	500	500
Paid-up	133.4	133.4
Retained profit	9.88	5.97
Income derived from investment		
depositors' fund	142.005	114.120
share holders' fund	41.972	20.577
Current account*	439.972	349.163
Saving account*	382.707	325.198
Investment account*	1,278.172	606.856
Others	446.948	330.465
Operating Revenue	88,126	60,518
Capital Ratio : Core	18.6%	17.5%
Dividends Rate	9%	8%
Earning per share	22.4 sen	16.4 sen
Profit before zakat, taxation and Monity Interest	29.9	21.9
Profit to deposits	87.7	63.4
Investments in securities	1,546.1	658.9
* group & bank		

Source: BIMB Annual Report 1994/1993

The credited profit to deposits increased by 38.3%. While current account, saving account, and investment account increased by 26.00%, 17.68% and 110.62% respectively. On the other hand the dividend paid by the bank increased from 8% in 1993 to 9% in 1994 while the returns, on investment deposits increased about 24.43%.

The high increase in the Bank's resources was also matched by a high increase in the use of these resources. The Bank's investment in securities has increased by 134.65%.

Table 6: The Financial and Investment Profile of Bank Islam Malaysia Berhad (BIMB): 1988-1994

	1988	1989	1990	1991	1992	1993	1994
	RM'000	RM '000	RM '000	RM '000	RM '000	RM '000	RM '000
Shareholders' Funds	85,750	89,376	92,396	99,384	175,834	196,315	212,284
Deposit from customers - group and bank							
Current Accounts	139,377	129,037	195,033	220,436	261,825	349,163	439,972
Saving Accounts	152,797	181,511	213,362	249,523	274,644	325,198	382,707
Investment Accounts	729,414	918,132	688,123	609,164	566,567	606,856	1,278,172
Others	643	525	124,426	96,016	217,573	330,465	446,948
Funds Allocated to:-							
Investment securities	432,452	507,841	379,069	337,263	428,110	594,634	1,508,176
Financing of customers	609,374	666,056	807,818	789,307	1012,185	996,473	976,989
Investment in subsidiaries	2,473	-	-	-	-	996,473	976,989
Statutory deposit with Bank Negara Malaysia	35,799	56,411	84,577	78,104	105,760	122,128	273,311
Dividends.	2%	3%	4%	5%	6%	8%	9%
Income from investment	64,322	80,876	81,298	84,184	91,961	114,120	142,005
Return on Investment:							
Deposits	14.87%	15.93%	21.45%	24.96%	21.48%	19.19%	9.42%
Net income *	5,829	9,504	12,946	13,437	15,388	26,189	31,333
Retained Earnings	2,469	3,503	3,869	4,884	4,253	5,971	9,873

* After zakat but before tax

4.1 1988 - 1992

During this period, BIMB is the only bank in Malaysia, principally engaged in Islamic banking business. Since its incorporation in 1983, the bank has shown its improvement. 1988 is the year, that is after 5 years of its incorporation, the improvements had been achieved in the context of a highly encouraging environment in the Malaysian economy. During these years (1988 - 1989) the Real Gross Domestic Product (GDP) grew by 8.7 % . In 1988 75% of the Bank's customers' deposits were in investment account, while the remainder was in current account and savings account. Approximately 95% of the deposits were due within one year, while the remaining 5% due in one to five years.

Table 6, shows the period from 1988 - 1992, BIMB experienced rapid growth in its available resources and investment operations. The bank shareholders' fund, current account, saving account and investment account increased rapidly. Besides that, the dividend paid by the Bank increased every year 2% in 1988 to 6% in 1992.

There is a high increase in the bank's resources followed by a high increase in the use of these resources. Investment operations conducted by the bank also increased from RM 432,452,000 in 1988 to RM 428,110,000 in 1992.

During the early years of its growth, BMB under taken short term investments of its fund in order to realise "reasonable profits in the shortest possible time". These are mainly the stock of commodities with various agents and the holding of the Malaysian Government Investment Certificates.

On the other hand the bank also disburse its funds among the major sectors of the economy such as agriculture, manufacturing, construction, wholesale and retail trade, transport and storage, financing, insurance and business services, real estate and new miscellaneous including housing.

5.0 ENVIRONMENT AND STRATEGY

5.1 An Overview

Karim's research (1987) had proved that there were interactions between the environmental determinism and financial strategy of Islamic banks which there - after affected their capital structure.

The recent literature on organization theory and business policy discussed in depth the relationship between environment and strategy. Both the disciplines focused on the environment - organization co-alignment process. However each has viewed the subject from different analytical prospectus and a different set of variables.

The business policy literature viewed organizations as playing a proactive and opportunistic role. The adaptation view is seen as a process of reflecting choice and selection (Child 1972), and much of the literature focused on the strategy variable (Hatten, et. al., 1978; and Mintzberg, 1972). The organization theory literature however, has adopted a more reactive proposition by considering the environment as a deterministic force to which organizations respond (Aldrich, 1979; Duncan, 1972 a; Lawrence and Lorch, 1967).

The recent studies of (Bourgeois 1980 and 1984; Smirich and Stubburt 1985; Astley and Van de Ven 1983; and Hrebiniak and Joyce 1985) attempted to develop a conceptual integration of the diverse literature which addressed the dichotomy of choice and environmental determinism in the adaptation process. the interpretation of Astley and Van de Ven (1983) and that of Hrebiniak and Joyce (1955) would be the main focus of these studies, hence, the insights derived from them can be used in explaining the changes in the capital structure of Bank Islam.

Astley and Van de Ven (1983) propose a framework that classifies the different school of organizational analysis on two dimension: deterministic versus voluntaristic orientation in theories of organizational adaptation, and (2) micro and macro level of organizational analysis. Their typology yields four schools of thought as shown in figure 1.

Figure 1
Four Views of Organization and Management
Deterministic Orientation... Voluntaristic Orientation

<p>MACRO LEVEL</p> <p>(Population & communities of organizations)</p>	<p style="text-align: center;">Natural Selection View</p> <p><i>Schools:</i> Population ecology, industrial economic, economic history.</p> <p><i>Structure:</i> Environmental competition and carrying capacity predefine niches. Industrial structure is economically and technically determined.</p> <p><i>Change:</i> A natural evolution of environmental variation, selection and retention. The economic context circumscribes the direction and extent of organization growth.</p> <p><i>Behavior:</i> Random, natural, or economic, environmental selection.</p> <p>Manager Role: Inactive. Q³</p>	<p style="text-align: center;">Collective-Action View</p> <p><i>School:</i> Human ecology, political economy, pluralism.</p> <p><i>Structure:</i> Communities or networks of semiautonomous partisan groups that interact to modify or construct their collective environment, rules, options. Organization is collective-action controlling, liberating and expanding individual action.</p> <p><i>Change:</i> Collective bargaining, conflict, negotiation, and compromise through partisan mutual adjustment.</p> <p><i>Behavior:</i> Reasonable, collectively constructed, and politically negotiated orders.</p> <p>Q⁴ Manager Role: Interactive.</p>
<p>MICRO LEVEL</p> <p>(Individual organizations)</p>	<p style="text-align: center;">System Structural View Q¹</p> <p><i>Schools:</i> System theory, structural functionalism, contingency theory.</p> <p><i>Structure:</i> Roles and positions hierarchically arrange to efficiently achieve the function of the system.</p> <p><i>Change:</i> Divide and integrate roles to adapt subsystems to changes in environment, technology, size, and resource needs.</p> <p><i>Behaviour:</i> Determined, constrained, and adaptive.</p> <p>Manager Role: Reactive.</p>	<p style="text-align: center;">Strategic Choice View Q²</p> <p><i>Schools:</i> Action theory, contemporary decision theory, strategic management.</p> <p><i>Structure:</i> People and their relationships organized and socialized to serve the choices and purposes of people in power.</p> <p><i>Change:</i> Environment and structure are enacted and embody the meanings of action of people in power.</p> <p><i>Behaviour:</i> Constructed, autonomous and enacted.</p> <p>Manager Role: Proactive</p>

Source: Astley and Van de Ven (1983, p. 247)