

# Jurnal scopus-profit determination

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## **Profit Sharing Ratio Determination of Mudharabah Contract in Indonesia Islamic Banks**

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### Abstract

The most idiosyncratic difference between Islamic and conventional banks is on the system applies that Islam reject the use of interest as its method for product pricing. Islamic bank offers the Islamic paradigm which is profit sharing represented in the mudharabah contract. Mudharabah uses profit sharing ratio in its pricing. This research try to reveal the method used by the Islamic banks in Indonesia in determining the ratio. Using qualitative approach, this study interviews the Islamic financial institution ie the Islamic banks owns by the government, Indonesia Islamic Council, and Islamic finance and banking experts. The finding is that the method used by all of the Islamic banks are the benchmarking model while some banks are not. This finding will benefit the Islamic financial Industry in determining the best practice of Islamic pricing in mudharabah contract.

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### Determinación del índice de participación en las ganancias del contrato de Mudharabah en los bancos islámicos de Indonesia

#### Resumen

La diferencia más idiosincrática entre los bancos islámicos y los convencionales es que el Islam rechaza el uso del interés como método para la fijación de precios de los productos. El banco islámico ofrece el paradigma islámico, que es el reparto de beneficios representado en el contrato mudharabah. Mudharabah utiliza la relación de participación en las ganancias en su precio. Esta investigación intenta revelar el método utilizado por los bancos islámicos en Indonesia para determinar la proporción. Utilizando un enfoque cualitativo, este estudio entrevista a la institución financiera islámica, es decir, a los bancos islámicos que posee el gobierno, el Consejo Islámico de Indonesia y los expertos en finanzas y banca islámicos. El hallazgo es que el método utilizado por todos los bancos islámicos es el modelo de evaluación comparativa, mientras que algunos bancos no lo son. Este hallazgo beneficiará a la industria financiera islámica en la determinación de las mejores prácticas de fijación de precios islámicos en el contrato de mudharabah.

#### 1. Introduction

Indonesia Islamic bank is developing and growing. From the statistics by Financial Service Authority (OJK) shows continuity of strong growth of its assets, financing, and deposits. All performance indicator of Islamic banking industry improves compared to previous year (year on year growth). On figure 1, we can see that on the the year 2017 financing side growth is 19,83% reached Rp291.18 trillion; the asset is 18.97% reached Rp435.02 Trillion, and the deposit 15.23% or reached Rp341.70 Trillion.

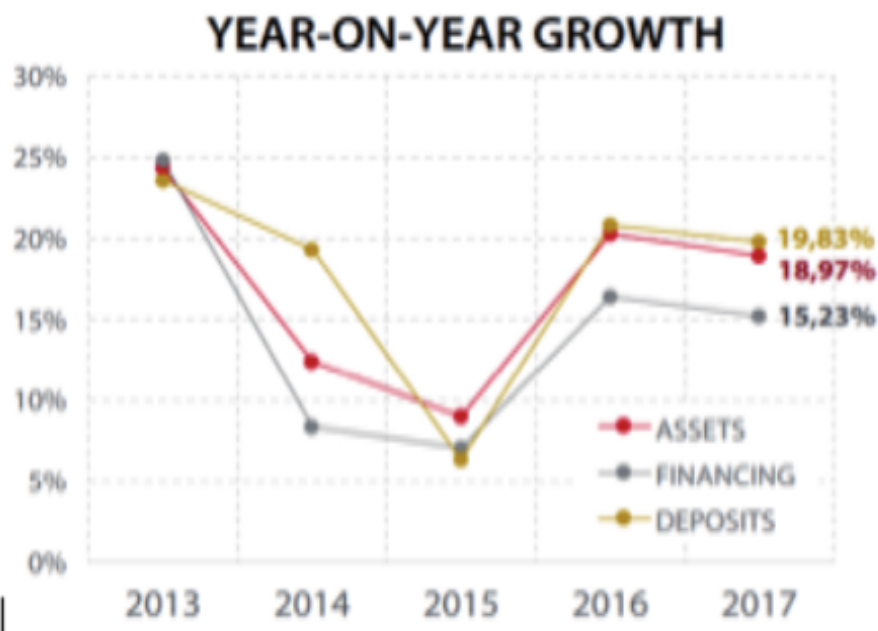


Figure1: Year on year growth of Indonesia Islamic bank's asset, financing and deposit. (Source: Indonesia Financial Service Authority, 2018)

What differentiates between the Islamic and the conventional bank is on the financial system. Islamic banking uses non-interest system which is called the profit and loss sharing system. This system uses many Islamic contracts which are sale (i.e. murabahah, salam and istishna), partnership (i.e. mudharabah and musharaka), lease (ijarah), and other contracts. (Siddiqui, 2008) However, the idiosyncratic differentiation is the mudarabah contract which uses the profit and loss sharing system.

### Types of Contracts Applied in Indonesia Islamic Banks

Contract	Murabahah	Musharakah	Mudharabah	Ijarah	Qardh	Istishna'	Others
Percentage	53.23%	34.87%	5.87%	3.15%	2.23%	0.41%	0.25%

Table.1. the percentage of the Islamic Contracts used in Indonesia Islamic banks (source: Indonesia Financial Service Authority, 2018)

Mudarabah is a business contract in which one party brings capital and the other brings personal effort and time to a business transaction. The proportionate share in profit from the business deal is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets no share of the profits for his labour. The financier is known as Rab ul Mall and the entrepreneur as Mudarib (Kettell, 2011, p. 63)

A preliminary research conducted in this topic which interviewed customers, managers, and experts of Islamic finance and banking shows evidence of a phenomenon of injustice experienced by the customers be it in the funding or financing of the banking products. The finding shows the profits shared between the parties did not satisfy the fairness obliged by shariah of Islam.

The point of interest of this research is on the technique or method used in determining the proportionate share or the profit sharing ratio (nisbah) by Islamic banks in Indonesia

## 2. Literature Review

There are many proposals be it through research or proposition which formulate or modelling the calculation of the nisbah. A focused study on the determination of the nisbah of mudarabah in a system where interest and PLS financing co-exist was proposed by Zubair Hasan (Hasan, 1985). The study proposed the aggregate profit-sharing ratio is a function of the overall rate of return on investment, rate of interest, degree of leverage, and risk premium. PLS financing is more profitable to financiers in the long run than interest financing.



Later researches on the topic are, the International Shari'ah Research Academy (ISRA) for Islamic Finance has collected a number of suggestions criticism of the model; and proposed the model for pricing of Islamic banks' product which is as alternative of benchmarking model (Omar Azmi M, Noor Md A, Meera Mydin Kameel A, 2010) i.e. Ghazali (Ghazali, 1994) gave a model known as "Rate of Profit Mechanism Model", Umar presented the model known as "Rate of Dividend of Islamic Banks Deposits and Investment Accounts Model", Usmani (2007) proposed the idea of "The Creation of an Inter Islamic Bank Market Based on Islamic Principles" while Hassan (2009) proposed "A Benchmark that can fit both Islamic & Conventional Banks". Another idea known as "Islamic Interbank Benchmark Rate (IIBR)" was given by a group of 16 banks working with industry associations and data provider Thomson Reuters. However, almost all of these alternatives are based on money market measures without highlighting how they relate to real economy. After analyzing all previously offered model for Islamic benchmark, ISRA research team have tested two models based on CAPM (Capital Asset Pricing Model) and APT (The Arbitrage Pricing Theory) (Omar Azmi M, Noor Md A, Meera Mydin Kameel A, 2010)

The recent papers i.e. written by Shahid Mohammad Khan Ghauri bring new light to the product development. In this case, Islamic finance should have its own footings in terms of product development. Ghauri analyzed that interest based benchmarks do not represent real economic activities (Ghauri, 2015). The alternative proposed by Asaad Ismail Ali and M. Zahid Siddique which study the Islamic banking in Pakistan. They proposes the model by linking bank's profitability with prices determined in the commodity market for ijarah, diminishing musharakah and murabaha contract. (Ali & , 2015).

However, most of the studies mentioned in the literature review has not mentioned how the Islamic Banks in Indonesia determine its profit sharing ratio of the mudarabah contract. This is the issue covered by this study which is to reveal the method used by Indonesia Islamic banks in determining the nisbah and whether it is comply with the Shariah law.

### 3. Research Methodology

A qualitative research using in-depth interview designed in answering the first question regarding the model used by Indonesian Islamic banks in determining the profit sharing ratio of its mudharabah contract. Informants in this study was determined by purposive method. The purposive sampling technique based on data sources with particular consideration which is set purposely by researcher (Tongco, 2007). The study interviewed Islamic banks managers which covers the treasury/Asset and Liability Committee (ALCO) of the banks or the representation. The criteria of the informants is the government's Islamic banks i.e. Bank Rakyat Indonesia Syariah (BRIS), Bank Syariah Mandiri (BSM), Bank Negara Indonesia (BNIS), Bank Tabungan Negara Syariah (BTNS). In answering the second question on the compliance of the Islamic bank's method with the Shariah law, the study interview expertise from different Islamic financial and banking institutions in Indonesia i.e. the Central Bank of Indonesia and National Sharia Board – Indonesian Council of Ulema (DSN-MUI), practitioner, and academician.

Data analysis in this research is done by three approach or method of analysis these are qualitative analysis, shar'e analysis, and synthesis analysis. Shar'e analysis is done on the problem or focus of research which is normative especially the verses of al-Quran and al-Hadith related to fair pricing, qualitative analysis is done on of Muḍārabah ratio determination, whereas synthesis is the attempt to combine the elements or separate components into a coherent unity.

### 4. Findung/Result

#### 4.1. Benchmarking

From the interview with the managers of Islamic banks in Indonesia and verified with the annual reports and data from the official websites, benchmarking is the commonly used model in determining the pricing of the Mudarabah contract. It can be seen from the graphics below

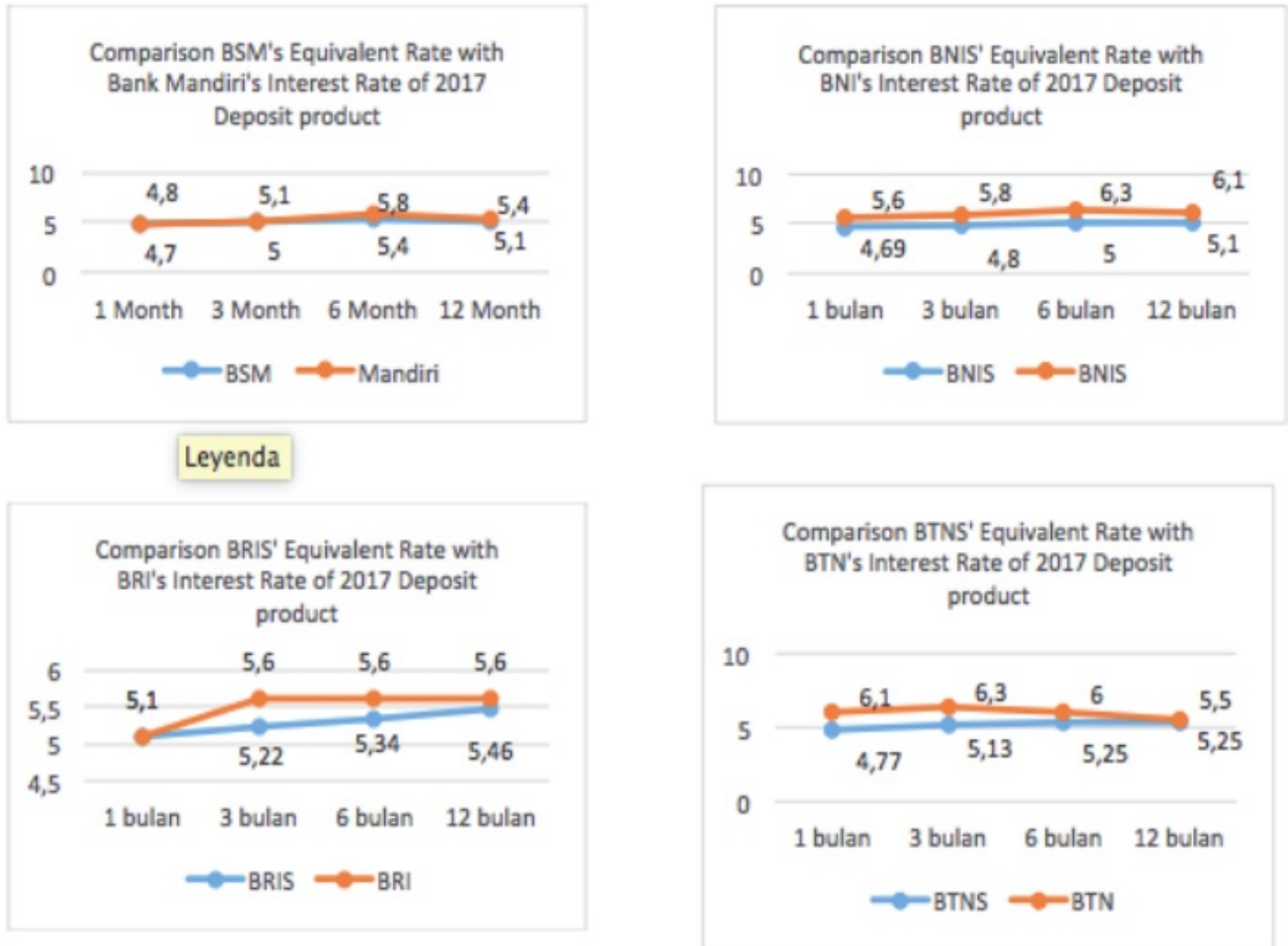


Figure 2: Comparison between Islamic bank and conventional bank in Indonesia

From the figure above, it can be seen that there's a same pattern which the Islamic banks (BSM, BNIS, BRIS, and BTNS) follow. This method is the benchmarking method. Of all the interviews with Islamic banks, they acknowledge, either explicitly or implicitly, that they generally apply the same standard of price determination, ie benchmarking the price of both Islamic and especially conventional banks which still dominating the market as a benchmark price standard in pricing for their banking products. In determining its price, each bank looks at the fluctuating rate of prices from other banks related to the price of its products so that it can provide the best price for its customers.



#### 4.2. Limited Negotiation

Negotiation is not provided to every customer. For customers of small deposit, bargaining or negotiation is not provided in its product features. To these small depositors, Islamic Bank will only offer the ratio, after which the depositors may agree or not. If agreed, then the customer will continue to deposit or continue with the partnership. If the customer does not agree, he or she is welcome to find another Islamic bank that offers a more attractive ratio.

While the customers of prime customer funding category or financing category with a very large funds then given the privilege to negotiate with the Islamic bank. In this case, each bank has different ways that characterize the bank concerned. The size of the Muḍārabah ratio is determined on the basis of negotiation and agreed by each of the contracting parties.

#### 4.3. Game Theory

One of the bank has developed analysis based on the level of competition. This is done in a market analysis and then measures the internal capabilities of the bank. In this bank, in general there are 3 pricing characters. The first is Simple, second is Complex, and third is Game Theory. Simple is as in general mechanism, ie follow the development of market situation. The complex performs calculations related to overhead cost, etc. There is a scenario A, if sensitive then raised then made the innovation through the theory where the impact is greater. If it is not sensitive then it will go down. And the third is trickier, that is using Game Theory. Game theory is used to analyze situations involving at least the parties whose actions affect each other. Through this game theory, it can analyze the behavior and possible strategies of the competitors in winning the competition and maximizing its profits.

#### 4.4. Liquidity Management

In terms of giving out the negotiation feature, the Islamic bank, firstly, considers the market price. Then the second is to pay attention to bank liquidity needs. If for example the bank liquidity is abundant, even though the market price is high, then the price of the product will not follow the market price. But if for example the market price is low, and also the bank is in need of financing, then the ratio is raised by accepting negotiations from customers.



## 5. Discussion

### 5.1. Benchmarking to Conventional Price

There is a divided opinions regarding this method. Some scholars considered this method try to find the market price even though the price using a non-Islamic model. The conventional bank's price that uses interest which is forbidden in Islam as its pricing model is considered as ongoing price in the market. While on the other side of the scholars consider this as tasyabbuh that is copying to the non-muslim. This is considered against the prophet Muhammad SAW saying for the muslim to have its own model in every way of their life, including in the pricing. That is why the scholars consider to find an Islamic pricing which is based on the real economic. This is to consider that the interest model is only based on the monetary economy not the real economic one.

### 5.2. Limited Negotiation

As the bank gives the negotiation limited to the prime customer which has large amount of fund for funding or customer involved in large business in the financing, the bank has created discrimination. It is since that in the muamalah (Islamic jurisprudence) especially in mudharabah contract, stated that there should be negotiation. The position between the rabul maal (investor) and the mudharib (manager of fund) is equal. There's not like the conventional borrowing which pose the creditor is superior than the debtor.

### 5.3. Game Theory in Islamic Perspective

The premise of game theory that should be underlined is that the players think rationally on a consistent basis. Therefore, a player will try to maximize what he wants to achieve. However, game theories fail to describe the social and interactive nature of human conflict. The assumption that humans are consistently rational and the inability to quantify relational dependence are the main factors of discontent. Game theory only treats communication as a simple exchange of information. Game theory can not quantify ambiguities in intentionality, changes in processes or variations in psychological and relational processes. So in this case what happens is a competition that puts self-interest or self-interest. In other words this is very contrary to Islam that puts togetherness in terms of maslahah (social benefit)

#### 5.4. Liquidity Management

In Islam, the social and economic aspects should be considered in business. The Islamic banks which uses liquidity management does not consider these aspect. It only consider the interest of the bank. The customers when come to the bank for funding or financing need has social and economic aspect that should be regarded. This would uphold the justice which put equality and equity in first place.

#### 6. Conclusion

The research shows that the Islamic banks in Indonesia apply the theory of benchmarking in determining the ratio of the mudharaba's profit sharing which become the pricing model of the banks. This is in accordance with theory that is discussed by some scholars mentioned in the literature review. It means the Islamic banks follow the theory of the benchmarking method. However, there are some banks which apply its own model which in accordance with the other price theory in conventional. The model are the game theory, limited negotiation, and liquidity management. The Islamic text and the scholars considers these models by the Islamic banks has not yet been fully compliance with the shariah law.

On how the best practice in determining the profit sharing ratio of mudharabah contract is still could not be found since each of the method practiced by the Islamic banks considers their method is the best one. This is why there is a need in finding the best way in profit sharing ratio determination of mudharabah contract.

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