

CHAPTER I

INTRODUCTION

1.1 Research Background

Nowadays, Islamic economics system become the world's concern as new solution for many economics problem that exists, since Islamic economics system is focusing more on economics welfare and the well-known interest-free system which support people. Islamic economics is rapidly developed at the current time because there are so many scholars that doing research in this subject and also many researchers that looking for a new solution for the problem that exists in this era.

Inside the Islamic economics system, there is Islamic bank as a place to apply the system itself. In Islamic bank, people can see and try how the Islamic economics system works in banking. There are many kind of contracts in Islamic bank, i.e trade contract, leasing contract, loan contract, investment contract, and others. With many kind of contracts in each category, people can find what they needs. In this study, the contracts are categorize into two categories, the financial contracts and social contracts.

Islamic banking using faith approach based as banking basic's system; means it is influenced by the Islam faith, contradictally with conventional banking. According to the Institute of Islamic Banking & Insurance (which was founded in 1990), Islamic banking refers to a system of banking or banking activities consistently to the principles of the *Sharia'h* (Islamic rulings) and its practical application through the development of Islamic Economics.

According to Al Baraka Banking Group (a licensed wholesale bank by the Central Bank of Bahrain founded in 1984), an Islamic bank is an institution that mobilizes financial resources and invests them in an attempt to achieve predetermined Islamically-acceptable social and financial objectives. Both mobilization and investment of funds should be conducted in accordance with the principles of the Islamic *Sharia'h*.

There are several principles associated with Islamic finance. First principle states no investment is made in contradiction to the *Sharia'h* rules. Thus, all investments must be made in line with *Sharia'h*. Second principle refers to the prohibitions under *Sharia'h*. The investments made under Islamic finance must not deal to undesirable and prohibited under *Sharia'h* which include but are not limited to *riba* (which is taking or receiving interest), *maysir* (which include speculation or gambling), *gharar* (which is the uncertainty regarding the subject matter or terms of a contract-this prohibition extends to trading the things one does not own), and investments involving alcohol, drugs and money laundering activities. Third principle is on risk sharing. Risk relating to any transaction must be shared between at least two parties. This ensures the parties invest funds and manage the funds share to the business risk in return for a share in profit (GTG, 2012).

Islamic finance does not recognize money as a commodity but rather as a means to carry out a transaction. The financing facilities offered by Islamic banking are in the form of contracts. These contracts are entered into by the bank and the recipient of funds. These contracts do not involve the charging of

interest but rather profit/loss sharing contracts. The most commonly used financing contracts are; *murabahah*, *musharakah*, *mudharabah*, *istisna*, *ijara* and *qard al-hassan*. Once the contract is approved, the bank will purchase the asset and the borrower will be given a period of time to pay the bank for the asset at a price which include the asset price plus a markup profit for the bank. This mark up is determined before the asset is bought and the borrower is made aware. The assets could be used as collateral for the transaction or the borrower provide another form of collateral. The borrower can pay in predetermined installments the whole amount owed (cost plus mark up).

According to Antonio (2001), *mudharabah* is a partnership contract between two parties where the first party (*shahibul maal*) provides the entire capital, while the other party (*mudharib*) become a manager, where the business profits split in percentage (ratio) as agreed, whereas if the loss is borne by the owners of capital as long as the losses not due to the negligence of the manager, if the loss was caused by negligence of the manager then the manager should be responsible for the losses. In *fiqh muamalah*, *mudharabah* as *qiradh*, which means form of cooperation between owners of capital (*shohibul mal / rabbul mall*) and business managers (*mudharib*) to conduct business where the profits of the business are split between two parties, as the agreement in the beginning.

Mudharabah is taken from the Arabic language that is *dharb, Adharbu fil ardhi* which means that is traveling to trade, as Allah says in Surah Al Mujammil verse 20:

“Indeed, your Lord knows, [O Muhammad], that you stand [in prayer] almost two thirds of the night or half of it or a third of it, and [so do] a group of those with you. And Allah determines [the extent of] the night and the day. He has known that you [Muslims] will not be able to do it and has turned to you in forgiveness, so recite what is easy [for you] of the Qur'an. He has known that there will be among you those who are ill and others traveling throughout the land seeking [something] of the bounty of Allah and others fighting for the cause of Allah. So recite what is easy from it and establish prayer and give zakah and loan Allah a goodly loan. And whatever good you put forward for yourselves - you will find it with Allah. It is better and greater in reward. And seek forgiveness of Allah. Indeed, Allah is Forgiving and Merciful.” (QS. 73: 20)

In the view of the jurisprudent scholars (jurists) *mudharabah* is an agreement between two parties that one party was issuing amount of money to other party for trade and profits split according to the agreement. *Mudharabah* is equivalent to equity financing in conventional banking. It is a profit sharing contract that is entered between Islamic bank and investor. Bank is the funds owner while the borrower (investor) will be the working partner.

The borrower will approach to bank through a trading venture in which they will require a certain amount of investment. The bank, therefore, provides principle capital into the venture while the borrower takes full charge of managing this venture for the purpose of maximizing its profit and to liquidate all its properties by its closing date.

Musharakah is derived from word *syarikah* which means mixing. Islamic jurisprudence scholars define *musharakah* as contract for people associated in capital or profit. The profit will be shared based on the earlier

agreement parties before they start the business. When the loss happen, the loss will be shared together according to the capability of each party. In general, *musharakah* is joint venture in starting business with profit sharing based on the agreement from the parties that join. (Muhammad, 2011)

According to Antonio (2001), *musharakah* is a partnership contract from two parties or more to form a certain business where each party should contribute their capital, and the profit or loss will be shared according to the agreement that the parties made. *Musharakah* is also an example of equity financing. Unlike *mudharabah*, this contract is a joint venture in which the bank and investor share in both the profits and losses from the venture. The parties to this contract are Islamic bank and borrower. The borrower ask the bank to have partnership with them for a business. The bank & borrower provides a certain amount of capital. The borrower will get the responsibilities to manage the business and the bank also has the right to appoint an employee as a representative in the partnership.

Murabahah is an activity of selling goods with the seller telling the price to the buyer, and then the buyer pay the price more than what the seller said as profit. (Dewan Syariah Nasional). According to Rifa'I (2002), *murabahah* in the Islamic banking concept is a purchase of goods in the original price with additional profit in agreement. In *murabahah* purchasing, the seller or the bank should inform the product price they bought and determine the profit as additional. This contract can be used as contract to buy

consumption goods or goods for business (providing capital) that the payment can be done in installment.

Monzer (1975) also explains *ijara* as a leasing contract. The bank purchases goods then leases them to the clients for specified rentals for a fixed period of time. Further arrangements can be made if the client wants to purchase the goods. In this contract, the Islamic bank is the lessor and the bank client is the lessee. The contract outlines are consist of the description of the asset to be leased, the amount of rentals charged for leasing the asset, the due date of submitting rentals and the whole period of the rent. The lessor is responsible for major maintenance that restores the leased asset to normal use in case of any deficiency; defect, unless such defect is caused by improper use by the lessee.

Istisna is a contract to manufacture goods, assemble or process them, or build a house or other structure according to the exact specifications and in a fixed timeline. Payments are made when property work property has finished. Financing *istisna* can only be done by means of two parallel contracts whose subjects are exactly similar: First contract is between the financier and the party that needs contracted things. Second contract is between the financier and the contractor who actually manufactures, constructs or builds the contracted things.

In conventional banks, the loan contracts are always include the interest, but in Islamic bank, the loan contract is should 100% interest-free. It is one kind of contract to help people continue their life or to start their own business. The interest-free loan contract name is *qard* or *qard al-hassan*.

Qard al-hassan is non profitable loans (zero-return). Al-qur'an really recommend all muslims to give loans to people in needs. The borrower only required to return for what they borrow, but they were allowed to add some bonus but as their own will. The borrower with *qard al-hassan* contract also got benefit from the financial services and moral support given by the bank. The return of the money is in a period agreed from both sides. Bank can take the service cost, but should not related with amount and period of the loans. So, the additional cost is only for the service that provided by the bank. *Qard al-hassan* become a way to strengthen and facilitate the business relations (Lewis and Algaoud, 2001).

In epistemological means, *qardhul* from the word of *qard* which means as "to cut". It means the wealth has been cut when given to the borrower. From the *hadits*, giving loans with *qard* is more please Allah rather than giving *sadqah*. This is true and no need to doubt it. It is Sunnah from Rasulullah and *Ijma'* from *ulama* (Maslehuddin, 1994).

In terminological means, *qard al-hassan* (benevolent loan) is a loans that given by social purpose only. In this case, the borrower does not required to return the additional money, except the amount of debt (Perwataatmadja and Antonio, 1999). *Qard al-hassan* is not a contract for financial profit purpose (Antonio, 2001).

In many places of the Holy Qur'an, Allah has mentioned and encouraged *qard al-hassan* by assuring better reward in this world and in the hereafter. As Allah says in Qur'an:

1. *He who will give Allah qard al hasan, which Allah will double into his credit and multiply many times. [Al-Baqarah (2): 245]*
2. *If you give Allah qard al hasan. He will double it to your credit and he will grant you forgiveness. [Al-Tagabun (64):17]*
3. *And give Allah qard al hasan. [Al-Maidah (5): 12]*
4. *And give Allah qard al hasan, it will be increased manifold to their credit. [Al-Hadid (57): 18]*
5. *Who is he that will give Allah qard al hasan? For Allah will increase it manifold to his credit. [Al-Hadid (57):11]*
6. *Establish regular prayer and give regular charity and give Allah qard al hasan. [Al Muzzammil (73): 20]*

The Sunnah of the Prophet [pbuh] is also very clear stated on this issue:

Abu Amama said that the Prophet [pbuh] said: *"In the night of the journey, I saw on the gate of heaven written, 'reward for sadqah (charity) is ten times and reward for qard hasan is eighteen times'. So, I asked the angel, how is it possible? The angel replied, "Because a beggar who asked might have already had something but a loanee did not ask for loan unless he was in need."* [Ibn Majah and Ibn Hisham]

The *hadis* describe *qard al-hassan* is one act of charity to help the others because people who ask for loan is people who already in a very need. Furthermore, the reward of *qard al-hassan* is greater than *sadqah*, it means that *qard al-hassan* is an action that worth to do to help the others.

Abu Hurayrah said, the prophet of Allah [pbuh] said, “*On the Day of Judgment, Allah will say: O son of Adam, I was sick yet you did not visit me. He will reply, O Allah, how could I have visited You since You are Lord of the Worlds? Allah will say: Did you not know that so-and-so a servant of Mine was sick, and yet you did not visit him? Did you not realize that if you had visited him [I would be aware of this, and would reward you] and you would have found me with him? O son of Adam, I asked for food from you but you did not feed me. He will say: My Lord, how could I feed you since You are the Lord of the Worlds? Allah shall say: didn't you know that so-and-so a servant of Mine asked food from you but you did not feed him, did you not realize that had fed him you would certainly have found [its reward] with Me? O son of Adam, I asked water from you but you did not provide Me with water. He will say, O Allah, how could I have provided you [with water] when You are Lord of the Worlds. Allah will say: so-and-so a servant of Mine asked you for water to drink but you did not provide him with water. Did you not realize that had you pr Surah ovided him with water to drink you would have found [its reward] with me?*” [Sahih Muslim]

The *hadis* explain concerning sharing to others is similar to give something to Allah, and Allah will rewards us something. The people who ask us food or water is a servants from Allah to let us have a chance to give food and water to others.

In another *hadis* reported by Abu Hurairah (R), the Prophet [pbuh] said, “*whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and Allah will facilitate him in this world and world hereafter.*” [Muslim].

From the *hadis* above, we can understand that a charity act is something that won't give us any difficult at all, but in reverse it will give us easiness in everything and it is what Allah said. Currently, *qard al-hassan* has been focused on introducing *qard al-hassan* as a financial, humanitarian, and welfare tool that can solve problem about inequalities and control the wealth in societies by helping the poor and the people that in disadvantage (Farooq, 2010; Obaidullah and Tariqullah, 2008; Khan, 2008; Mojtahed and Hassanzadeh, 2009; Najeeb and Lahsasna, 2012). These contemporary studies

have set up the role of *qard al-hassan* on improvement of the human condition through religious way as well as the historical data collected from various countries in the past couple of decades. The concept is mostly used in providing microfinance by NGOs, charities, religious organizations, etc. The results have not been good enough in reducing poverty, improving conditions and gaining popularity among Muslim communities due to several reasons (Khan, 2008).

According to Widiyanto et al (2011), providing *qard al-hassan* financing to the poor cannot solve the poverty problem on its own and requires better way which involves broader aspects such as education, information and morality. Extending financing through *qard al-hassan* has been insufficient and inefficient in solving the poverty problem because the lack of ability to profit, high administrative and transaction costs, high risk and lack of demand from the users (Ariffin and Adnan, 2011). To decrease losses and added capital to *qard al-hassan*, several researchers have recommended using charities and donations related with *qard al-hassan*, the problem regarding lack of funding can be solved afterwards (Ahmed, 2007; Febianto and Ashany, 2012). According to Farooq (2007), one of the advantages of *qard al-hassan* funding is that the source of financing can be emerge from the local community so that the *qard al-hassan* financing model does not rely on the government or commercial sources. Rather than focuses on developments in individual practices of charities and donations, there is much work remaining in terms of putting these pieces back into a whole system to identify social economic problems (Ahmed, 2007).

Qard al-hassan is a product of Islamic bank, which there are many other products in Islamic bank, but *qard al-hassan* got a special function where this contract is a contract that got social function to the society as a help to the people who doesn't have money and they want to borrow it from the Islamic bank. The Islamic banks bring their business on the basis of equity-participation (*musharakah*, and *muqarabah*), leasing (*ijarah*), lease-purchase (*ijarah wa iqtina* '), cost-plus financing, (*bay' murtaba~ah*), and rent-sharing. These institutions have also innovated in planning some new financial instruments like Participatory Term Certificates (PTC), Term Finance Certificates (TFC), *Muqaraqah* Bonds, Leasing Certificates, etc (Khan, 1994).

Banks and other financial intermediaries are the main source of external funds to firms. Intermediaries provided more than 50 percent of external funds that happened from 1970 to 1985 in the United States, Japan, the United Kingdom, Germany, and France (Mayer, 1990). Contrary, Islamic bank got their role as intermediaries. A financial intermediary is a risk neutral agent, with personal wealth equal to zero. The intermediary receives funds from depositors to lend to entrepreneurs and is entrusted the task of monitoring the outcomes of entrepreneurs' projects on behalf of depositors (Diamond, 1984).

As intermediaries, Islamic bank help people to get their capital or just to get money to continue their lives. There are many Islamic contract that makes the bank being intermediaries, in example *qard al-hassan* contract. In *qard al-hassan* contract, banks use the saving money in Islamic bank, to lend the borrower. In this case, the banks become intermediaries for the investor or

people who save their money in the Islamic bank and the borrower with *qard al-hassan* contract. While the bank doing their function as financial intermediary and running their business, there are many risk that appear corresponding with the contract that provided by the Islamic bank.

Risk financing is a risk happened cause from other party could not fulfil their responsibility to pay. Risk financing can happen by bank activities likes financing, treasury and investment, and trade finance funds that noted inside banking book or trading book (Veitzal, 2007).

By providing this kind of contract, the Islamic bank got their role in helping peoples. Besides that, Islamic bank also has a commercial purpose to keep the business exist. According to those purpose, profitability of Islamic bank is an important thing to keep it on the good condition because if it doesn't, then it will become a sign to that Islamic bank that they should do their job better than before and for the worst case, it can cause a closure to that bank.

The performance of commercial banks can be affected by internal and external factors (Al-Tamini, 2010; Aburime, 2005). Profit is the ultimate goal of commercial banking (Ongore & Kusa, 2013). It is important to measure the financial performance of a bank as a means of knowing the progress of the bank and the managers and shareholders are able to tell how the bank is doing.

Banks rely on the use of financial ratios to achieve this. To measure profitability of commercial banks, a variety of profitability ratios are used of which, return on equity (ROE), return on assets (ROA), and net interest margin (NIM) are the major ones (Murthy & Sree, 2003, Alexandru et al, 2008). Those are some of the bank performance indicators.

The ROE is measured the efficiency of a company employs the owner's capital (Khrawish, 2011). It is a financial ratio refers to how much profit a company earned compared to the total amount of shareholder equity invested or found in the balance sheet (Ongore & Kusa, 2013). It is calculated as follows; $\text{Net income} / \text{Bank capital}$. The better ratio of ROE, the higher the profitability of the bank and the more effective management utilized by shareholder capital.

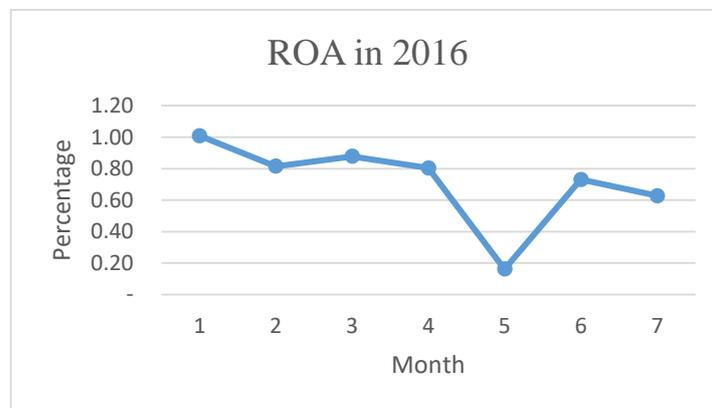
The ROA is a ratio of income to its total assets (Khrawish, 2011). It measures the ability of bank management to generate income by utilizing company assets at their disposal (Ongore & Kusa, 2013). ROA is measured by; $\text{Net income} / \text{Bank assets}$. Wen (2010), states that a higher ROA shows more efficient in using company's resources.

Those two ratios, ROE and ROA, can be used when measuring the profitability of Islamic banks. The third ratio (net interest margin), cannot be used since Islamic bank principles prohibit the charging and receiving of interest. In general, the profitability of an Islamic bank can be seen from their return on assets (ROA) from their annual report or report from each month. From this factor, the profitability of the bank can be calculated and seen how

good they are or how bad they are in the business they were run. Return on assets is an indicator about how the profitability of the Islamic bank conditions related to their assets. It is used to identify how their business condition from the profit perspective.

The graph bellow is the return on assets (ROA) of Islamic Bank in Indonesia:

Figure 1.1 ROA of Islamic Bank in Indonesia



Data from: SPS year 2016

Figure 1.1 describe, the performance of Indonesian Islamic bank based on return on assets (ROA). The performance from January to July is decreasing, and moreover on April to May, ROA's start increase from May to June. In this case, the return on assets (ROA) of Islamic bank in Indonesia doesn't show any good result because the ROA on June is lower than the ROA on January in 2016. According to the previous research conducted by Hasan and Bashir (2003), the Islamic banks' profitability measures respond positively to increase in capital and loan ratios.

Whereas from hypothesis of this research, the decreasing in performance of Indonesian Islamic bank caused by the Islamic contracts, because all the contracts had interest free.

For Islamic banks, the net income does not include interest income but rather income realized from financing activities (deals), other operating income and non-operating income. Income from financing activities refers to the mark up charged when offering financing contracts and the profit gained from equity contracts. The bank's assets in this case majorly include the financing activities of the Islamic bank, unlike loans for conventional banks.

Each financing contract the bank offers contributes to the profit of the bank. The contract can either increase profitability or decrease profitability depending on their proportion to the overall financing activities of the bank. The return on assets (ROA) is an indicator to identify how a company do their business; are they profitable or not; and are they need to do something or just keep doing the business as it is.

In this research, researcher has an aim to study the influence of Islamic contracts with the profitability of Islamic bank, since Islamic contracts doesn't have any interest.

1.2 Research Question

Based on the background of this research, there are some questions that appear and need answers, there are:

1. Does *mudharabah* influence the return on assets (ROA) of Islamic bank?

2. Does *musharakah* influence the return on assets (ROA) of Islamic bank?
3. Does *murabahah* influence the return on assets (ROA) of Islamic bank?
4. Does *ijarah* influence the return on assets (ROA) of Islamic bank?
5. Does *istishna* influence the return on assets (ROA) of Islamic bank?
6. Does *qard al-hassan* influence the return on assets (ROA) of Islamic bank?

1.3 Research Objectives

Based on the research question, the Objectives of this research are:

1. To study the influence of *mudharabah* to the return on assets (ROA) of Islamic bank.
2. To study the influence of *musharakah* to the return on assets (ROA) of Islamic bank.
3. To study the influence of *murabahah* to the return on assets (ROA) of Islamic bank.
4. To study the influence of *ijarah* to the return on assets (ROA) of Islamic bank.
5. To study the influence of *istishna* to the return on assets (ROA) of Islamic bank.
6. To study the influence of *qard al-hassan* to the return on assets (ROA) of Islamic bank.

1.4 Research Benefits

The benefits which could be gained from this research are:

1. For society, this research would encourage people to use the Islamic contracts in Islamic bank without worrying whether it will affect the Islamic bank profitability or not.
2. For bank, this research will give information to the bank whether Islamic contracts are profitable or not, and also encourage the Islamic bank to provide these contracts because it will help the people who are really in need.
3. For academic environment, this research can be continued or re-research about the influence of Islamic contracts on profitability of Islamic bank.

1.5 Research Plan

In order to understand the undergraduate thesis clearly, so the researcher divided the materials into several sub-chapters with systematic writing as follows: **Chapter I, Introduction;** This chapter describes the general information that the research background, problem formulation, purpose and benefits of the research, the scope of research, time and place of study, research methodology, and systematic research. **Chapter II, Theoretical Framework and Hypothesis;** This chapter contains the theory that some excerpts taken from the book, in the form of understanding and definition. This chapter also explains the basic concepts of Islamic economics system, Islamic Bank, the main characteristics of Islamic banks, Islamic

contracts : *mudharabah, musyaraka, murabahah, ijarah, istishna*, and *qard al-hassan*, financial intermediaries, financial risk, financial performance, profitability, return on assets (ROA). **Chapter III, Research Methodology;** This chapter contains the definition of variables that used in this research, data and the source, the methodology of regression test analysis. **Chapter IV, Research Findings;** This chapter describes the influence of Islamic Bank Contracts to the return on assets (ROA) of Islamic bank in Indonesia. It also contains the result from the analysis of regression test, the result table and diagram, the analysis of empirical result with the theoretical framework and previous study. **Chapter V, Conclusions;** This chapter contains of conclusion from the research, suggestion for the policy maker of Islamic bank in Indonesia and suggestion for the next research.