

**Toward an Ideal Balance of
Islamic Banking Products Portfolio**
The Case of *Sharia* Bank Industry in Indonesia

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ABSTRACT

The Islamic Banking Industry is growing rapidly in many countries, yet some important problems are yet to be faced. This includes the perception of some Muslim societies towards Islamic banking operations, accounting issues and particularly, in regard to the industries product portfolio.

In the case of Indonesia – but perhaps also in the larger context – there has been concerns raised about the imbalance of product portfolio [Adnan 2003; 2005, Tohirin 2003, Muhammad 2005]. It is commonly known for example that the *murabaha* product has dominated product portfolio since the beginning of the industry's operations.

Although this issue is not related to *fiqh* concepts, many are concerned that product portfolio imbalance will cause an unevenness between the monetary or financial sector and the real sector of businesses. In other words, the situation will not reflect the notion of an Islamic economics concept, which is concerned about balance and harmony among all economic sectors.

This paper offers a solution to this particular problem, with a view towards implementation of an Islamic economy.

Key words: Islamic bank, products, portfolio

Introduction

The debate continues among some economists about the existence of Islamic Economics and or Banking [see Arief, 1985; Mannan, 1986; Adnan, 1996 to]. Many Muslims however would be delighted to witness the recent resurgence of Islamic Economics. The key indicator regarding this development is that the growth of Islamic banking has occurred not only in Muslim countries like Indonesia, Malaysia, and Pakistan or in the Middle East, but also in the countries where Muslims are considered as minority. This includes the United Kingdom, The United States, Denmark, and Singapore. “According to the London-based Institute of Islamic Banking and Insurance, Islamic banks manage some \$US260 billion in funds around the globe, with clients throughout the Muslim and non-Muslim worlds” [Rodgers, 2005].

In the case of Indonesia, the growth has been deemed ‘remarkable’, although Indonesia is not the first Muslim country to implement the Islamic financial system. Since its inception in Indonesia in 1991, there are now more three thousand financial institutions operating under Islamic financial principles. These include over 20 general Islamic banks, which have around 350 branches in the regions, 88 *Sharia* rural banks and more 3000 sub-rural and non-formal *Sharia* financial institutions. These are famously known as the *Baitul Maal wa at-Tamwil* (BMT) [see Bank Indonesia, 2005; Adnan, 2000].

In spite of rapid growth in quantity, the industry yet has to face a number of challenges. Among these problems is concern about product portfolio, where *murabaha* has significantly dominated other products and services (See: Adnan, 2003, Tohirin, 2003, Muhammad, 2005). The dominant position of *murabaha* over other Islamic banking products can be seen from the following tables:

Table 1: The Growth of Financial Islamic Banking in Indonesia since 2001

			Dec 2001	Dec 2002	Dec 2003	Share 2003
Total Asset			2,719	4,045	6215	
Financing			2,050	3,276	4682	100%
	<i>Murabaha</i>	billion Rp	1,420	2,324	3381	72.21%
	<i>Mudaraba</i>	billion Rp	403	499	671	14.33%
	<i>Musharaka</i>	billion Rp	54	60	134	2.86%
	Others	billion Rp	173	393	496	10.59%

Third Party Fund		billion Rp	1,807	2,917	4334	100%
	Account	billion Rp	300	359	548	12.64%
	Saving	billion Rp	591	815	1252	28.89%
	Term Deposit	billion Rp	916	1,473	2534	58.47%
Paid Capital		billion Rp	524	524	626	
	ROA	%	3.05	1.33	0.79	
	ROE	%	15.84	10.31	7.83	
	FDR	%	113.45	112.31	108.03	
	NPL	%	4.01	4.12	3.91	
Market Share						
Total Asset		%	0.25	0.36	0.56	
Financing		%	0.57	0.80	1.05	
Third Party Fund		%	0.23	0.35	0.51	
Number of Banks			86	91	94	
Number of cash offices			182	229	310	
Resource: Bank Indonesia [in Mujiyanto, 2004]						

Table 2: The financing composite of Sharia banks in Indonesia (November 2004)

Type of Financing	Outstanding		Y-o-Y Growth		Share	
	2003	2004	2003	2004	2003	2004
<i>Musharaka</i>	305.997	1.195.187	408.4%	314.3%	5.5%	10.9%
<i>Mudaraba</i>	794.244	1.907.390	59.3%	131.4%	14.4%	17.4%
<i>Murabaha</i>	3.955.615	7.275.753	70.2%	86.9%	71.5%	66.3%
<i>Istisna</i>	295.960	310.596	34.1%	7.4%	5.4%	2.8%
Others	178.151	289.692	3.1%	69.2%	3.2%	2.6%
Total	5.530.167	10.978.618	68.8%	100.8%	100.0%	100.0%

Source: Bank Indonesia, 2004.

These tables clearly indicate that there is an imbalance of product portfolio among all products or services potentially offered, where the *murabaha* has significantly dominated over products. Burhanuddin Abdullah, the Governor of the Indonesian Central Bank, has also indicated his concern about this during in his speech delivered in Jakarta in March 2005 [Adnan, 2005]. A same view has also been raised by Muhammad [2005] and others.

Murabaha: What Is Wrong With It?

Those who are not concerned with this issue may ask: just what is wrong with *murabaha*? The answer to this question is contingent on perspective. The Islamic jurisdiction, or *fiqh* point of view, has no objection at all to the application *murabaha*. It rather discusses the lawfulness of the product, but never relates to its domination over other products or services.

The Islamic banking industry also indicates the same view on this issue. This product is even considered to be the favourite, since it is simple to operate as well as easy to socialize to both customers and the community as a whole. Customers also find that the product is easy to be understood and practice, since it is familiar as in the general credit a conventional bank practices. It is perhaps the main reason why the *murabaha* has become the most important choice among other products that Islamic banks can offer.

By definition, *murabaha* means a trading of particular property sold by a bank to its customers [see Antonio, 2000, 154]. In this regard, the [Islamic] bank will purchase any particular property wanted by a customer at a certain price, and then sell back the property to the customer. In this selling, the bank increases the price with some agreed margin. As it is a pure trading transaction, Islam has allowed it to be practiced, as stated clearly in the Holy Qur'an 2:275: "*That because they say: 'Trade is like usury'. But Allah hath permitted trade and forbidden usury*".

There is no problem with the *murabaha* conceptually; however some are concerned about it because of following factors. First, since it is very much comparable to a 'loan' in conventional practice, it is also potentially – and in some cases – has been abused, both by Islamic bank officers and by customers. Not surprising then, a general complaint is that basically there is no significant difference between *murabaha* and a conventional loan, except for the term used¹.

A prepared explanation is not enough to convince many parties who believe that there is no difference between the *murabaha* and the loan in a conventional banking context. At a practical level, there is also a complaint that sometimes Islamic bankers sell this product as conventional bankers sell a loan, where 'the interest' term is simply changed into 'a margin'. Ironically, according to some complaints, Islamic bankers still apply the term 'interest' with 'margin' interchangeably. Another related issue is that the margin applied by *Shariah* banks is higher than the interest rate in conventional banks. As a matter of fact, there is a clear difference between interest and 'margin' or 'profit earned' as the latter is fully allowed by the Qur'an [See The Holy Qur'an Al-Baqarah (2) :275]. It is not merely a matter of semantics.

This practice continues to have the potential to disrupt the image of the *Sharia* banking. At the same time this uncertainty has the potential to decrease or even destroy customer trust which has been developed over a period of decades. The common view suggests that the negative image of *Sharia* banking is partly because many cannot appreciate the difference between *murabaha* and a conventional loan, or, alternately, that *Sharia* banks have failed to show the clear distinction between a conventional loan and the *murabaha*.

¹ Author is frequently asked about this issue in seminars. Many Muslims have complained about the implementation of *murabaha* as it is assumed to be similar the loan in conventional banks.

Second, in a macro economic context, the *murabaha* is closer in nuance to the monetary sector than real sector. Moreover, the *murabaha* has so far been utilized more for consumptive products than those of productive ones. The emphasis more on the monetary sector than the real sector should be viewed critically. There are at least two other factors that must be considered. The first is certain facts about Indonesian economic history both before and during the monetary crisis that hit Indonesia beginning from the mid-1997. It is important to note that the economic policies applied by Indonesian Government have stimulated the financial sector to dominate the real sectors. The result is that the real sectors had been left far behind the financial sectors. Because of this, many competed to make money without creating economic value. As a result, Indonesia experienced 'bubble economic growth'. Thus, an economic trigger was all that was necessary to plunge the Indonesia into a serious economic downturn, or monetary crisis, which has proved resistant to quick recovery.

The second factor is more serious. Islamic economics is basically developed on a foundation of 'fairness'. One important Islamic tenet is the need to apply an appropriate balance among the economic sectors. It is believed that prosperity will exist only when economic value added is created optimally. The position of the financial sector is merely aimed at supporting the real sectors. It is then questionable if financial sector completely dominates the real sector.

As alluded to earlier in this paper, the stress on selling the *murabaha* product by Islamic financial institutions might be a trigger for the domination of the financial sector over the real sectors. It is why some parties are concerned as to the current behaviour of most *Sharia* banks, which appears to focus on and sell more *murabaha* than other products. On the other hand, some other products which might be able to provide a balance effect at the macro economic level, are not sufficiently promoted and sold. Partnership products such as *mudaraba* and *murabaha* are believed to be able to leverage this balance, however, one needs to critically examine the reasons behind the trends shown by the current performance of *Sharia* banks.

A Partnership Products: *Mudaraba vis a vis Musharaka*

Islamic banks have been promoted extensively as the financial institution which offers society and individual customers the opportunity to be fair in their transactions. At the same time, it is firmly stated, that the bank will not deal with any kind of *riba* or usury-like transactions, since they are strictly prohibited by Islamic law or *Sharia* [Qur'an 2:275-279].

There are basically four types of partnership transaction regarded by Islamic jurisprudence as fit in practice, namely: *mudaraba*, *musharaka*, *muzara'a* and *musafaqa* [See: Antonio, 2000]. However, the last two categories are not practicable in the banking industry, since they are more closely related to agribusiness. *Mudaraba* and *murabaha* have been frequently discussed to show the spirit of partnership in the Islamic business model as well as the concept of fairness among business players. Nevertheless – as shown in above table – these two products contributed much less than *murabaha* to the industry. For example, In 2004 the *mudaraba* and *musharaka* contributed only 17.4% and 10.9% respectively to the industry, while the *murabaha* enjoyed 66.3% of total product sold.

The *mudaraba* is defined as a contract or collaboration between two parties and is related to commercial business. The one who provides capital is called the *shohibul maal* or a 'capital owner', while the other party is known as the *mudarib* or 'business operator'. If the business earns a profit, the profit is then shared between the *mudarib* and *shohibul maal* proportionately, according to the agreement made before the business was started. However, if the business suffers loss, there are two options available. The First option occurs when the loss is considered to be 'a normal loss', which is beyond the control of *mudarib*. Such a normal loss will be burdened to capital owner (*sohibul maal*), the *mudarib* will take responsibility by not to requesting payment for contributed skills or the time spent on business activities. The Second option occurs if and when the loss was caused by the *mudarib*[s] negligence. Under these circumstances, all risk or loss will be the responsibility of the *mudarib* alone.

Mudaraba is not originally introduced by Islam. It has in fact been known and practiced well before the Islamic tenets were delivered by Prophet Muhammad (*pbuh*). Prophet Muhammad (*pbuh*) was recorded in history as a *mudaraba* practitioner when he became *mudarib* to a *sohibul maal* known as Siti Khadijah, the rich widow who later married the Prophet Muhammad (*pbuh*). The *mudaraba* is reasonably understood as an ideal agreement or contract between two or more parties in a commercial business environment. It provides a perfect business platform for critically considering fairness among participants. However, it requires full transparency, particularly from the *mudarib* side, otherwise moral hazards ensue – as it is commonly understood in agency theory – which cannot be totally avoided [See Muhammad, 2005].

Table 1 in fact shows that *mudaraba* contributed only 14.4% in 2003 and 17.4% in 2004 of product portfolio of the *Sharia* banking industry. Examples of obstacles to implementation of *mudaraba* are as follows. First, *mudaraba* needs transparency and accountability. *Mudarib* is given full authority to manage business. The *sohibul maal* seems to have no [or very limited] access to business operations. Because of this, the *mudarib* has almost unlimited power in running the business. No control can be applied, even by the *sohibul maal*, except that the *mudarib* has to report to *sohibul maal* regularly as agreed by two parties. From the *sohibul maal* [s] point of view this is not favourable, particularly in the situation where culturally many traders do not show integrity and honesty in running a business.

Second, to a large extent business society in Indonesia is not ready to practice the transparency and accountability required. There are perhaps two others factors to be considered related to this point. One is the lack of readiness in Indonesian business culture to be open to other parties. Most business persons – particularly those who are categorized as medium and small business players – are not prepared to be open. The other factor is poor accounting practices among business managers or owners, particularly for medium and small scale business firms.

For these reasons, it is hard to expect that *mudaraba* financing products can be 'sold' at a higher rate than the current position. The development of an ability to handle these current problems may take long period of time to resolve. The study conducted by Muhammad [2005] shows how much effort must be expended to solve these problems.

Musharaka on the other hand is an alternative to think about. It is defined as a contract between two or more parties, where every party should contribute capital, not only in the form of cash or other non-cash [fixed] assets. Furthermore, all parties are expected to contribute certain skills, which are needed by the business to prosper [See Antonio, 2000; IAI 2003]. Since interest or usury is strictly prohibited, the return that will be received by every investor is in the form of a dividend. However, in the case that the business suffers a loss, all parties are also responsible proportionately, according to the agreement made or a proportion of the capital invested.

Musharaka is not a new concept to many, since it is also commonly practiced in many places. In the Western financial system, *musharaka* might be paralleled to Venture Capital. Venture Capital firms are recognized to have played an important role in supporting particular types of business. It is widely recognized that Bill Gates started Microsoft by support of a Venture Capital firm [Timmons, 1999]. Many other world class corporations such as Federal Express and Apple Computers have the same experience [See for example Boyett and Boyett, 2001; Dollinger, 2003; Megginson, Byrd and Megginson, 2003]. This should inspire the *Sharia* bank Industry to follow in the foot steps of Venture Capital firms. Indeed there is genuine opportunity in this area of *Sharia* banking because Conventional banks have no right to peruse the same policy.

Partnership and Real Economic Sector

Partnership products are basically closer to Islamic economics than *murabaha*, *salam* or *istisna*². Islamic economics have put stress on the process of value adding. The existence of Islamic financial institutions must be seen from the perspective that they are supporting the implementation of Islamic economics as a sustaining function. Because of this, the policy applied by those Islamic financial institutions must also be directed towards this basic notion. It cannot be the other way around.

An example is the case of *mudaraba* as discussed earlier. *Sharia* bank officers consistently raise the problem that they face problems in 'selling' *musharaka* financing product. Among others, is the issue of transparency and accountability as well as the lack of employee involved in *musharaka* financing project. Unlike the *mudaraba* product, which also raises the issue of transparency and accountability, the same issue in *musharaka* cannot be analogized.

Based on discussions the author has had with a *Sharia* bank officer, the officer was basically concerned with the constraint of available employees. The officer argued that every *musharaka* financing project must involve one of his staff to commit in helping the partner in marketing, production, or accounting. Under these circumstances if the officer signed one *musharaka* financing project every month, he would effectively 'loose' one employee per month. In a year the officer would then potentially 'loose' 12 employees, while at that time the officer only had 8 employees in his branch. Furthermore, normally every *musharaka* financing project ends after three to five years. As discussed earlier in this paper, the *musharaka* type of financing is always committed to such an obligation. This seems to be the root of the problem for the *Sharia* banking system. Is there a solution?

² One should not see this in absolute sense. Yet, trading has also a relation to economic value adding, particularly if the traded property can be categorized as productive goods, instead of consumptive ones.

A Solution Proposed

It is undeniable that a partnership product is closer to Islamic principles of business comparative to other more widely known products. Between two types of partnership products (*mudaraba* and *musharaka*), the *mudaraba* seems to have more problems to solve than the *musharaka*. This is because of the following reasons: (a) the *mudaraba* seems to be totally controlled by the *mudarib*. The access of *sohibul maal* is extremely limited, if not at all. Because of the risk to the *sohibul maal* tends to be higher, and (b) in the case of a loss, again there is a tendency that the *sohibul maal* should bear more risk than the *mudarib*. (c) Unfortunately the change of culture in Indonesia necessary to show transparency and accountability from the side of *mudarib* in general is at this time relatively hard to expect.

Because of the above reasons, in order to sustain an Islamic economy, Islamic financial institutions should consider applying *musharaka* financing projects to a greatest extent possible. Some constraints faced so far are not unsolvable.

As was recognized earlier in this paper, one basic problem is the lack of employee numbers in the *Sharia* bank system. From the bank's perspective, it is not financially wise to recruit staff to fulfil the requirements of a *musharaka* financing project only, since the bank will be committed to have a fixed human resources cost with its related long term complexities.

The problem of providing expert staff to support *musharaka* financing is actually an opportunity, if it is seen from that way around – either in collaboration with *Sharia* banks or not – it may establish a firm specifically aimed at providing expert staff in a particular skill area, such as accounting, marketing, operation, or finance, for temporary contracts or certain periods.

The establishment of this specific type of firm is feasible from almost every perspective, particularly given the current economic situation of Indonesia. There is no need to dedicate a huge amount of investment to start such a business. *Sharia* banks can also join as investors by buying shares offered.

The main job of this firm is to have a range of staff having different skills in business, such as accounting, marketing, production or operations, human resources management and so forth. Again, in the current Indonesian context, experts from different skill backgrounds are abundantly available, since there is so many staff that is recently retrenched by their companies because of the current difficult economic conditions and resultant organizational rationalization. The skill and experience of such people should be recognized and utilized positively to help growing companies who are financed under a *musharaka* contract with an Islamic bank. Should the skills of staff be improved before they are employed, specific training can be provided which covers Islamic and related studies. Thus these prospective employees will have better management skills combined with Islamic values.

The business operation of the firm is also basically simple because it only includes the following: recruiting skilled and experienced staff, developing staff if necessary through training, workshops or seminars, and finally 'selling' them to *Sharia* banks which will apply a *musharaka* financing contract to their customers.

In this regards, these win-win solutions can be achieved by every party involved. Multi-positive effects can be expected. First, *Sharia* banks will attract skilled and experienced staff who will understand *musharaka* financing projects. The staff will be responsible on behalf of the *Sharia* bank to run the project together with the customer. In this regard, he or she will oversee the project as well as help with any necessary task needed by the customer's company or project. Indirectly, all related issues of transparency and accountability will be address and hopefully solved.

Second, the project or customer's firm will enjoy not only the capital invested, but also the expertise provided by the skilled and experienced staff implanted on behalf of *Sharia* banks. Having skilled and experienced staff working in the project will enable the project or company to directly learn how to manage their business better. The experience and know-how transformation through implanted staff will ensure the sustainability of the company.

Third, the establishment of a new company will directly assist the un-employed members of community who – perhaps – have been recently retrenched by their respective companies. In other words, the newly established firm will be able to absorb many un-employed skilful and experienced people and provide them with important employment.

Over all, the Indonesian Government should be pleased with this project, since it directly solves one of their most fundamental problems. The decline in the un-employment rate will trigger further multiplier effects in the country's economy, such as the increasing of general purchasing power, the growth of taxable income, the decline in poverty (and also perhaps criminality), the improvement of industrial output and so forth.

Concluding Remarks

Islamic religion, revealed through Prophet Muhammad (*pbuh*) is provided as a blessing to all nature³ (The Holly Qur'an 21: 107). This includes all human beings and in fact all kinds of creatures. This is no matter where one is living, the language he or she is speaking, and the colour of one's skin. Because of this, all policies must have the concept of fairness a foundation.

The current development of the *Sharia* bank has shown a tendency that there is an imbalance in product portfolios offered by the bank. A close review of this issue shows obstacles the *Sharia* banking industry must face in implementing partnership product. In this regard, the author suggests a humble alternative solution to improve the product portfolio by establishing new firms which collaborate with one another to realise the blessings to be found for human society in sound Islamic financial practice.

³ Stated normally in Arabic as: "*Rahmatan lil 'alamin*".

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