Governance of Profit and Loss Sharing Financing in Achieving Socio-economic Justice

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Research Background

• The significant increase of Islamic bank asset from 7.8 trillion rupiahs in 2003 to become 356.5 trillion rupiahs in 2016.

• Rapid development of Islamic banks worldwide and in Indonesia (29% in 2008 based on Deutsche Bank 2011 report).

• Vatican said that to restore confidence due to the global economic crisis, Western banks should look at the rules of Islamic finance (Tiberge, 2009)
# The Development of Indonesian Islamic Bank 2003-2016

<table>
<thead>
<tr>
<th>Number of Islamic Commercial Banks</th>
<th>2003</th>
<th>2008</th>
<th>2013</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>(BMI established in 1992 and BSM 1999)</td>
<td>2</td>
<td>5</td>
<td>11</td>
<td>13</td>
</tr>
</tbody>
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<tbody>
<tr>
<td></td>
<td>8</td>
<td>27</td>
<td>23</td>
<td>21</td>
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<table>
<thead>
<tr>
<th>Number of Islamic Rural Banks</th>
<th>2003</th>
<th>2008</th>
<th>2013</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>84</td>
<td>131</td>
<td>163</td>
<td>166</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Asset of Islamic Banks (billion Rupiah)</th>
<th>2003</th>
<th>2008</th>
<th>2013</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>7,859</td>
<td>51,248</td>
<td>248,109</td>
<td>356,504</td>
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<tbody>
<tr>
<td></td>
<td>0.64%</td>
<td>2.19%</td>
<td>4.93%</td>
<td>5.21%</td>
</tr>
</tbody>
</table>
Research Background

• Warde (2000) noted two characteristics of Islamic finance: (1) risk sharing philosophy where profit and loss sharing (PLS) is preferred rather than predetermined interest rate; and (2) the promotion of economics and social development through specific business practices and zakat (almmsgiving).

• In financing contract, Islamic banks in Indonesia mainly use murabahah and less portion of PLS.
# Islamic Bank Financing based on Types of Contract

<table>
<thead>
<tr>
<th>Types of contract</th>
<th>2008</th>
<th></th>
<th>2013</th>
<th></th>
<th>2016</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount Rp Billion</td>
<td>Portion Rp Billion</td>
<td>Amount Rp Billion</td>
<td>Portion Rp Billion</td>
<td>Amount Rp Billion</td>
<td>Portion Rp Billion</td>
</tr>
<tr>
<td>Mudharabah &amp; Musyarakah</td>
<td>13,616</td>
<td>35.6%</td>
<td>53,499</td>
<td>29.1%</td>
<td>86,973</td>
<td>37.1%</td>
</tr>
<tr>
<td>Murabahah</td>
<td>22,486</td>
<td>58.9%</td>
<td>110,565</td>
<td>60.0%</td>
<td>133,956</td>
<td>57.1%</td>
</tr>
<tr>
<td>Istishna</td>
<td>369</td>
<td>1.0%</td>
<td>582</td>
<td>0.3%</td>
<td>878</td>
<td>0.4%</td>
</tr>
<tr>
<td>Ijarah</td>
<td>765</td>
<td>2.0%</td>
<td>10,481</td>
<td>5.7%</td>
<td>8,105</td>
<td>3.5%</td>
</tr>
<tr>
<td>Qardh</td>
<td>959</td>
<td>2.5%</td>
<td>8,995</td>
<td>4.9%</td>
<td>4,731</td>
<td>2.0%</td>
</tr>
<tr>
<td>Total</td>
<td>38,195</td>
<td>100.0%</td>
<td>184,122</td>
<td>100.0%</td>
<td>234,643</td>
<td>100.0%</td>
</tr>
</tbody>
</table>
Research Questions

• What motivates Banks in using PLS financing?
• How is the governance of the PLS?
• Are there any differences in governance among different types of IFIs?
• What best practices can be learned from the IFIs to enhance socio-economic justice?
Research Objectives

• To understand the governance of profit loss sharing financing in achieving socio-economic objectives.
Literature Review – Socio-economic Justice

• McKee (1979) - justice is constant and perpetual will to render everyone his rights. Justice is directed towards others and is essential for peace and cohesion of society.

• Burdenski and Dunson (1999) - A truly strong and vibrant economy, economic decisions must consider human consequences and moral content. There is no truly just economy unless the poor are included in its process.
Several directions of Economic Justice (Thurow, 1973)

1. Perspective of process and procedure
   Economics is considered as fair or equitable when individuals agree on the rules of the game and any outcome of that game is thus considered just.

2. Perspective of individual preferences.
   Justice is achieved when economic outcome is equitable in accordance with the individual preferences of citizens of the country and society reaches the distribution of economic resources that generates the most agreement.
Several directions of Economic Justice (Thurow, 1973)

3. Perspective of merit

Based on this perspective, justice occurs when resources are distributed in the same manner as merit, so that, the person who contribute most will get most.

4. Perspective of common good

Justice can be achieved if the distribution of economic resources has maximised the common good.
Said and Elangkovan (2014)

Economics system is only concerns with stockholder interests with less or without concerning the public interest.

Zakaullah (2000)

The conflict between the self-interest and the interests of the society is much alive and becoming heating up from day to day.

Stiglitz (2009)

What happened in the economics is not zero-sum game any more but more at negative-sum game. The bad behavior of economic players have affected negatively other people in the form of the economic crisis.
Efforts to Solve Problems with Conventional Economics

• Corporate Social Responsibility has been introduced in the conventional economics but seems not enough as the crisis keeps coming in.

• Attention is now being given to the religious values especially Islamic values.

• Vatican viewed that to restore confidence due to the global economic crisis, Western banks should look at the rules of Islamic finance (Tiberge, 2009)

• Mauro et al (2013) - Islamic Financial system has been growing in Europe as an alternative for non-Muslim client seeking ethical investments and greater risk diversification
Two characteristics of Islamic finance (Warde, 2000):

1. Risk sharing philosophy where profit and loss sharing is preferred rather than predetermined interest rate;
2. The promotion of economics and social development through specific business practices and zakat (almsgiving).

Tabash and Dhankar (2014) outlined six main principles of Islamic finance:

1. Prohibition of Riba (interest);
2. Avoidance of gharar (excessive uncertainty);
3. Advocating risk and return sharing;
4. Avoiding harmful products and activities;
5. Sanctity of contract; and
6. Promoting Zakah (almsgiving).
Profit and Loss Sharing

- **Mudharabah** and **Musyarakah** are two modes of transaction representing PLS mechanism.
- Both are used for generating business, and the resulted profits/losses are shared together.
- Under **Mudharabah**, the entire capital is provided by one party called **Shahibul Maal** (capital owner), under **Musyarakah** both parties contribute capital.
- All losses as long as not because of the manager’s negligence, are beared by capital owner of **Mudharabah**, but in **Musyarakah**, the losses are shared by both parties bassed on their capital contribution.
PLS and Socio-economic Justice

- Tabash and Dhankar (2014) - PLS mechanism can encourage people to become partners and work together rather than in creditor-debtor relationship.

- Shaikh (2017) - under Islamic financial institutions, it can develop a framework in which equity financing could be used to fund microenterprises that will employ poor people with related skills.

- Majid and Kasim’s study (2015) on the contribution of Islamic finance to economic growth, found significant unidirectional causality of Islamic bank’s development to economic growth in Malaysia.
Research Method

Research Object

- Five IFIs consisting of one Islamic commercial bank (ICB), two Islamic rural banks (IRB) and two Islamic micro finance of Baitul Maal wat Tamwil (BMT).

Research informant

- Branch Manager of ICB, Directors of IRB, Manager of BMT and Head of R&D unit of BMT

Data collection method

- Interviewees with Directors and Managers of the IFIs from June to July 2016.
Findings and Discussion

Level of financing for PLS scheme

Finding

• One BMT with five years old with asset 25 billion rupiahs had 10% portion while the other one of 22 years had 60%. Similarly one rural bank with 15 years old have 30% portion while the other older one of 25 years had 60%.

• Newly operating IFIs have increasing portion of PLS financing, those which are relatively old, tend to be standstill

Discussion

• IFIs which are older in terms of age have higher portion compared to those which are relatively new.

• IFI might need time to learn how to manage PLS financing before using it in greater scale. At the beginning, they start with lower portion of PLS financing, than stop at the certain level when already had high portion.
Findings and Discussion

Motivation in using PLS scheme

Finding

• “There are some reasons why we use profit sharing financing... perhaps it is much more because we can not use Murabahah.” (IRB 1)

• “One day, Mr Adiwarman [Islamic bank expert in Indonesia] came to Yogya and visit us. He told us that supplies could not use Murabahah. So Murabahah is for tangible asset, can be used to the end” (IRB 2).

• “Increased, the trend is increased. This is because we direct our customer to use Mudharabah and Musyarakah if they need cash. For Murabahah and Ijarah, we never give cash... we pay it directly [to the supplier].” (BMT 1)

Discussion

• PLS financing is the second option after Murabahah due to the tight regulation besides the nature of profit sharing financing which is riskier.

• Motivations in using PLS financing can be classified into two: scholar driven and customer driven.
Findings and Discussion

Government regulation on the PLS financing

Finding

• “If it is Murabahah... month 10 with instalment, 11 no instalment, still considered as “current”, until 13 still “current”, then in 14 “substandard”. In Musyarakah, when you got to month 2 with no instalment, immediately considered “substandard”. If it is substandard, the consequence [for bank] is to record provision around 10%.” IRB 1

• “Rescheduling can only be done once. One time rescheduling from “current” is still considered “current”. But when it reaches the second rescheduling, then it becomes “substandard”.” IRB 2

Discussion

• The regulation is stricter for PLS based financing than for sales based or rent based financing in terms provision for loan losses (PPAP) treatment and rescheduling frequency.

• Problems with the provision and rescheduling treatment do not appear in the BMTs type of IFI, because BMT is subject to loose regulation of Cooperation Ministry.
Findings and Discussion

Governance Practices - Financing duration

Finding

• The maximum financing duration for PLS is 3 years which is much shorter than in *Murabahah* which can be up to 10 or 15 years.

• “For working capital, our regulation is three years. If we use Mudharabah, it’s yearly basis. But it can be extended” (Interviewee ICB).

Discussion

• This internal policy shows a very careful response of IFIs on the PLS.

• It may also mean that PLS scheme is difficult to be expected as a financing instrument for a long-term relationship which is something needed for sustainable socio-economic development.
Governance Practices - Contract approval

Finding

• In general, contract approval in the IFIs refers to the approval process in Murabahah financing or 5Cs (character, capacity, collateral, capital, and condition) in conventional banks.

• It was found that character aspect is the most crucial.

• The process of selecting customer, is much tighter in the PLS scheme rather than under Murabahah.

• Based on the interview fieldwork, it was found that all IFIs in this study requires collateral for all financing under PLS scheme.

Discussion

• These practices limit the potential of PLS scheme to enhance socio-economic justice where many people with new business needs support from this type of financing.
Findings and Discussion

Governance Practices - Contractual cost

Finding

• Most of IFIs in this study charged customers for contractual costs such as administrative cost, notary cost, stamps and insurance.

• An IFI with higher level of awareness of shariah issues had different point of view:
  What I understand.... Administrative cost is the real cost incurred for a contract. So.. this cost is difficult to count, how much paper, how much ink. Rather than we cannot count it and I am afraid we receive revenue which is not our right, so we just omit it. En Sha Allah, we will receive revenue from other sources. (Interviewee BMT 1)

Discussion

• The more careful an IFI interprets shariah guidance, the less it takes advantage from contractual costs which is a common practice in conventional banks.

• IFIs which takes loose interpretation of shariah guidance, will act almost similar with conventional banks on the contractual costs.
Governance Practices - Basis of sharing

Finding

• IFIs use revenue (gross profit) rather than net profit as the basis for sharing.
• Based on customer’s type of business, Islamic rural bank and Islamic microfinance use both net profit sharing and gross profit sharing.
• For IFIs which use net profit sharing, they do often experience the fact of not receiving profit as expected because of high costs

Discussion

• Customers, when they have chance to do moral hazard, they would execute it to maximise their profit.
• This may indicate that the use of net profit as the basis of sharing, is still not secure for IFIs in Indonesia.
• As IFIs give opportunity to use both net profit sharing or revenue sharing, this promotes better socio-economic objective in fulfilling public needs.
Findings and Discussion

Governance Practices - Timing for paying principal and profit sharing

Finding

• There are some variations found during fieldwork interviews about the timing of paying back the principal and profit sharing by customers.
• There is a practice that the principal had to be paid at the same time with the profit sharing
• There is also a practice to allow customers only pay for profit sharing, and then after a few months they start to pay profit sharing plus the principal.

Discussion

• PLS based financing offers flexibility for customers to pay for instalment of the principals and for the agreed shares of profit according to the nature of their business.
• This is very helpful from the customers’ perspective in developing their business as it allows flexibility. Therefore, in this aspect of governance, the PLS scheme supports for achieving better socio-economic justice.
Findings and Discussion

Governance Practices - Handling of bad financing

Finding

• IFIs used systematic way in handling bad financing based on what causes the problem. There are two main causes of bad financing: cyclical and structural.
• In PLS financing, the IFIs in the survey do not charge penalty in terms of additional payment when there is delay.
• All IFIs were also found to anticipate problems through the use of insurance which cover life and fire accident.

Discussion

• This is obviously different from conventional banks where delay payment will automatically add revenue interest for the bank. In this regards, PLS scheme in IFIs have better mechanism in achieving socio-economic justice.
• The financial institutions are directed to be a partner to help customer solving their problems rather than just waiting and got advantage through charging interest when the customers are in difficulties.
Governance Practices - Customers’ Empowerment

Finding

• There are varieties of empowerment activities that have been undertaken by the IFIs. These cover religious activities, management and business training and collaboration.

• An ICB informed that they have routinely visited their customers, give consultation on strategy improvement or improving their human resources quality.

• The costs incurred for that activities used the IFIs money and not charged to the customers.

• However, the empowerment process for the PLS financing does not reach to the stage of sending person from the IFIs to manage their partner’s business.

Discussion

• The nature of PLS financing has pushed IFIs to empower their customers which supports the socio-economic justice.
Findings and Discussion

Governance Practices - Shariah compliance supervision

Finding
• During the fieldwork interview, it was found that shariah supervision is not only undertaken by Shariah Supervisory Board, but also by the FSA.
• Shariah concerns are not only about the IFIs but also their customers.
• IFIs do often experience with customers’ dishonesty in various phases of PLS cycle such as using money other than for business, not reporting real profit and postponing obligation payment.

Discussion
• This situation in one hand has directed some IFIs with less concern with shariah aspect just to use indicated percentage rather than real profit and loss sharing.
• On the other hand, IFIs which is still consistent with pure PLS concept, are challenged to educate the public.
Conclusion and suggestion

• Government the regulation issued by the FSA for PLS scheme has worked well to prevent the IFIs to use sales and purchase contract when it actually only suits with PLS financing.
• However, the IFIs will use the PLS scheme after they really cannot apply Murabahah contract.
• Some governance practices of PLS financing were found supportive for socio-economic justice. These are the flexibility in using basis of sharing either revenue or net profit basis; flexibility in timing of payment schedule following the nature of business cycle; no penalty of payment delay; and putting more efforts for IFIs to assist customers to survive in their business.
• It was found in one IFI with higher awareness of shariah compliance, that it does not charge administrative fees for contract signing. Meanwhile, some non-supportive governance practices are short duration of financing and unwillingness to finance new business.
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- It was found in one IFI with higher awareness of shariah compliance, that it does not charge administrative fees for contract signing. Meanwhile, some non-supportive governance practices are short duration of financing and unwillingness to finance new business.
Suggestion for further research

There is a need to consider:

1. Using questionnaire survey to all IFIs in Yogyakarta;
2. Interviewing regulators and customers as source of information;
3. Extending the study at national level.