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

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Abstract

Purpose – This study elaborates governance practices of Profit and Loss Sharing (PLS) financing in achieving socio-economic justice.

Design/methodology/approach – Five Islamic Financial Institutions (IFIs) in Yogyakarta, Indonesia, were investigated through a series of interviews with their Directors and Managers from June to July 2016.

Findings – Some governance practices of PLS financing were found supportive for socio-economic justice. These are providing alternative in sharing basis either based on revenue or profit, flexibility in timing of instalment payment based on the nature of business cycle; no penalty of payment delay; and putting more efforts to assist customers in their business. Meanwhile, some non-supportive governance practices are short duration of financing and unwillingness to finance new business. It was found that PLS scheme is not the first choice to use, and IFIs with younger age tend to have less PLS financing than the older ones. Besides being worry with the higher risk of return, IFIs considered Government regulation on PLS is tighter in terms of provision and rescheduling treatment. However, the regulation has worked well to prevent IFIs to use sales and purchase contract when it actually only suits with PLS financing.

Research limitations/implications – This study is limited to investigating five IFIs in Yogyakarta, Indonesia. Furthermore, there is a need to consider using questionnaire survey to all IFIs; interviewing regulators and customers as source of information; and extending the study at national level.

Originality/value – In-depth interview and analysis of governance practice of PLS is the original contribution of this study which gives theoretical foundation on the role of PLS in achieving socio-economic justice.

Keywords - Islamic Financial Institutions, Profit and Loss Sharing Financing, Socio-economic Justice, Governance Practices

Paper type - Research paper
1. Introduction

Islamic Finance has been promoted as an approach which can uphold socio-economic justice in business. Hamzah (2014) former chairman of Islamic Development Bank, said that the socio-economic and moral well-being of the whole community is the overall mission of Islamic finance. This differentiates Islamic banks from conventional banks where the focus is not only on profitability but also on social benefits to the community. Kahf (1999) explained that Islamic finance promotes economic development through direct link to the real economy; prohibition of harmful products and activities; and promotion of economic and social justice. This in turn drives Islamic finance not to make profit from activities that do not add to the real economy such as debt rescheduling, debt swap, speculation and other purely monetary activities. Chapra (2008) added that the mechanism of return on savings and investment which is closely linked to the real sector had given Islamic finance a flexible adjustment mechanism in the case of unanticipated shocks. The mechanism also prohibits excessive risk taking eg. complicated securitization.

Deutsche Bank (2011) reported that during the 2008 financial crisis, Islamic banks have enjoyed 29 percent growth in assets to reach more than 600 billion USD in 2008. It added further that the development of Islamic banks could not be stopped by the turmoil in the middle east nor by the Euro Zone debt crisis as the fact of surging demand for shariah compliant products not only from financiers in Muslim countries but also investors globally. Later, Tiberge (2009) reported that Vatican has expressed their views on banking that to restore confidence due to the global economic crisis, Western banks should look at the rules of Islamic finance.

Islamic financing in Indonesia basically has started since 1980 when a group of students of Institute of Technology Bandung established Islamic micro finance called Baitul Maal waT Tamwil (BMT) which was under cooperation legal status (Yaya et al, 2014). Nowadays, this type of IFI has spread all over Indonesia. By 2010 there have been more than 4,000 BMTs being established serving around 3 million customers (Rizky, 2015). This type of IFI is based on the concept of making balance of commercial (Tamwil) and social (Maal) function. The commercial function is performing funding and financing activities in accordance of Islamic law, while the social function is collecting and distributing zakah, infaq and shadaqah to the needy. Although the name is still popular as BMT but later the social function slightly declined, after the issuance
of Zakah Act 2013 where restrictions have been imposed that only licensed agencies that can collect and distribute zakah.

In terms of banking, the first Islamic bank is a privately owned Bank Muamalat Indonesia (BMI) which has been operating since 1992. After the 1997 financial crisis, the Indonesian government established Bank Syariah Mandiri (BSM) and developed a number of regulations to facilitate sustainable growth of Islamic banks. The initiatives made by the Indonesian Central Bank (Bank Indonesia), has resulted in the establishment more Islamic full pledged commercial banks, Islamic business units under conventional bank, and Islamic rural banks. Table 1 shows the increase of Islamic bank asset from 7.8 trillion rupiahs in 2003 to become 356.5 trillion rupiahs in 2016. In terms of their market share in Indonesia, the development shows steady expansion from 0.64% in 2003 to 5.21% in 2016.

<table>
<thead>
<tr>
<th>Table I. The Development of Indonesian Islamic Bank 2003-2016</th>
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<tr>
<td><strong>Number of Islamic Commercial Banks</strong></td>
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<tr>
<td>2 (BMI established in 1992 and BSM 1999)</td>
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<tr>
<td><strong>Number of Conv. Banks with Islamic Business Unit</strong></td>
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<tr>
<td>8</td>
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<tr>
<td>27</td>
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<tr>
<td>23</td>
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<tr>
<td>21</td>
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<tr>
<td><strong>Number of Rural Banks</strong></td>
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<tr>
<td>84</td>
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<tr>
<td>131</td>
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<tr>
<td>163</td>
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<tr>
<td>166</td>
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<tr>
<td><strong>Total Asset of Islamic Banks (billion Rupiah)</strong></td>
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<tr>
<td>7,859</td>
</tr>
<tr>
<td>51,248</td>
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<tr>
<td>248,109</td>
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<tr>
<td>356,504</td>
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<tr>
<td><strong>Market share</strong></td>
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<tr>
<td>0.64%</td>
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<tr>
<td>2.19%</td>
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<tr>
<td>4.93%</td>
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<tr>
<td>5.21%</td>
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Source: Bank Indonesia (2003, 2008, 2013) and OJK (2016), owned calculation for market share

As Islamic banks widely use PLS for their depositors, they have been expected by academics to use greater portion of PLS contract for financing than to use Murabahah sale and purchase contract which is quite close to the interest rate mechanism. However, the steady expansion of Islamic bank in Indonesia is not similarly reflected in the increased portion of PLS based financing of Mudharabah and Musyarakah. Table 2 shows that in 2003, at the early development of Islamic banks, Mudharabah and Musyarakah contracts comprised 19.9% of their financing scheme and increased up to 35.6% in 2008. The trend then went down in 2013 to 29.1% but increased again in 2016 reaching 37.1%.

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Tabel II. Islamic Bank Financing based on Types of Contract (in billion rupiahs)

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<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>Portion</td>
<td>Amount</td>
<td>Portion</td>
</tr>
<tr>
<td>Mudharabah and Musyarakah</td>
<td>1,099</td>
<td>19.9%</td>
<td>13,616</td>
<td>35.6%</td>
</tr>
<tr>
<td>Murabahah</td>
<td>3,955</td>
<td>71.5%</td>
<td>22,486</td>
<td>58.9%</td>
</tr>
<tr>
<td>Istishna</td>
<td>295</td>
<td>5.3%</td>
<td>369</td>
<td>1.0%</td>
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<tr>
<td>Ijarah</td>
<td>181</td>
<td>3.3%</td>
<td>765</td>
<td>2.0%</td>
</tr>
<tr>
<td>Qardh</td>
<td>959</td>
<td>2.5%</td>
<td>959</td>
<td>2.5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5,530</td>
<td>100.0%</td>
<td>38,195</td>
<td>100.0%</td>
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Source: Bank Indonesia (2003, 2008, 2013) and OJK (2016), owned calculation for market share

This unstable trend for PLS type of contract gives a signal that there is a need to understand what motivates them in using PLS financing, how the governance of this type of contract within Islamic banks; are there any different governance among the IFIs; and what best practices can be learned from each other to enhance socio-economic justice. By understanding these issues, the Islamic banks would have better knowledge that may lead to the increased use of PLS based contract.

2. Literature Review

Thurow (1973) said that although modern economics was initially developed to search for a definition of economic justice, but the search has largely abandoned. Therefore, by 1950’s, questions of economic equity had not been discussed in basic economics textbook except noting that it was necessary for market economy to start with a just distribution of economic resources. He added that such ‘just’ distribution was left blank without further detail explanation and vaguely handed over to political process.

McKee (1979) defined justice as constant and perpetual will to render everyone his rights. He asserted that justice is directed towards others and is essential for peace and cohesion of society. Based on his study, Thurow (1973) suggested that economic justice can be defined from several directions. First, from the perspective of process and procedure. In this perspective, 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. Second, from the perspective of individual

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1 As it does not use interests in its operation, the term ‘financing’ is used more common in Islamic bank rather than the term ‘loan’ or ‘lending’.
preferences. Under this perspective, 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. Third, from the 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. Finally, from the perspective of common good, it is defined that justice can achieved if the distribution of economic resources has maximised the common good.

Burdenski and Dunson (1999) reminded that economics is not only about what it produces but should also about how it touches human life. Therefore to build a truly strong and vibrant economy, economic decisions must consider human consequences and moral content (Burdenski and Dunson, 1999). In its implementation, it should be always asked how do the economic choices contribute to a sensitivity to those in need? How it strike a balance between labor and leisure that enlarge capacity for friendships, for family life and for community. Questions of human solidarity should be kept in mind in the realization whether the economics decisions help or hurt people, strengthen or weaken family life, and advance or diminish the quality of justice in communities. Burdenski and Dunson (1999) underlined that there is no truly just economy unless the poor are included in its process.

Capitalism has been heavily criticised as the source of global economy and financial crisis. Said and Elangkovan (2014) pointed that problem with the conventional economic system is because it only concerns with stockholder interests with less or without concerning the public interest. This can be understood because under capitalism, self-interest is regarded as essential engine for prosperity. Said and Elangkovan (2014) argued that the conventional economic theory ignored the possibility of rational individual would hurt the interests of the society to maximize his or her own interests. Zakaullah (2000) said that the conflict between the self-interest and the interests of the society is much alive and becoming heating up from day to day.

The recurring economic crisis had made many parties worry about its long term impact for future generations. To anticipate further crisis, Stiglitz (2009) calls for more social protection and efforts to provide jobs. He believed that social protection will improve inequality which has been widely occurred at this time. In his opinion, a number of common practices of banking industry which is far from ethical value and derivative markets which have no contribution to the real economy have made worst the crisis. He assessed further that what happened in the
economic 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.

Numerous efforts have been undertaken to anticipate problems with the conventional economy. Corporate Social Responsibility (CSR), for instance, has been introduced and incorporated in modern economy. However, this seems not enough as the crisis keeps occurring and becoming worst. An attention has now been given to incorporate religious values in the modern economy especially to Islamic finance approach which has been developing rapidly in Muslim countries and some Western countries. The call to look at Islamic values is not only voiced by Muslims academics and economics players but also by non Muslim including Vatican Administration (Tiberge, 2009). Furthermore, Mauro et al (2013) found that Islamic Financial system has been growing in Europe not only to provide religiously acceptable financial services for Muslim communities, but has also been an alternative for non-Muslim client seeking ethical investments and greater risk diversification.

Islamic finance had been defined in various ways ranging from the narrow perspective of interest free banking to the very broad perspective of financial operations conducted by Muslims. Warde (2000) suggested that Islamic finance is all financial practices that are based, in their objectives and operations, on Qu’ranic principles. He noted two characteristics of Islamic finance: (1) risk sharing philosophy where profit and loss sharing is preferred rather than predetermined interest rate; and (2) the promotion of economics and social development through specific business practices and zakat (almsgiving).

Looking at its underlying social and ethical goals, Pesendorfer and Lehner (2016) agreed that Islamic banking is able to serve as an ethical alternative for banking sector. Tabash and Dhankar (2014) outlined main principles of Islamic finance are: (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 (alms giving).

In Islam, money itself has no intrinsic value. Therefore a Muslim cannot make money from money such as lending money and then expect for additional money. Tabash and Dhankar (2014) underlined that money should be used in a productive way whereby wealth can only be generated through legitimate transactions such as trade and investment in asset or business. There are six main modes of transactions under Islamic finance. They are Mudarabah (trust

*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. However, they are different in two aspects. First, under *Mudharabah*, the entire capital is provided by one party called *Shahibul Maal* (capital owner), meanwhile under *Musyarakah* both parties contribute capital. Second, 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 based on their capital contribution. Tabash and Dhankar (2014) believed that this mechanism can encourage people to become partners and work together rather than in creditor-debitor relationship. Therefore, this mode of transaction can be expected to support for providing stimulus for economics growth. Shaikh (2017) suggested that under Islamic financial institutions, it can developed a framework in which equity financing could be used to fund microenterprises that will employ poor people with related skills. In addition, 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.

*Mudharabah* scheme has been widely used by Islamic banks as a mode of transaction with their depositors to raise funds. The use of this scheme had given advantage for Islamic Bank to be financially stronger and less risky than conventional banks (Cihak and Hesse, 2008). However, on the financing side, PLS mode of transaction is used lesser than *Murabahah* cost-plus mark-up. Furqaini and Yaya (2016) said that there have been stable portion of *Murabahah* financing in Indonesia banking sector at 59% from 2007 to 2014. But on the other hand, for *Mudharabah* financing, it has gone down significantly from 20% to 7.4%. If both *Mudharabah* and *Musyarakah* to be combined together, there have been decreasing from 35.8% to 31.1% during 7 the years period.

Dar and Presley (2000) analysed that the condition of having low portion of PLS is caused by the imbalance between management participation and IFIs control rights on the financed project. The existing practice is that the IFI has very limited control rights which create higher risk on the IFI’s side. Ascarya (2013) asserted that the root causes of low PLS are 1) internal problems including upper management, human resources and technical aspects; 2)
system conditions such as conventional bank domination, and unsupportive environment and competition; and 3) externalities such as society, the authorities and customers. This suggests that there is a need for IFIs to have better governance that the IFIs can be more confident in using the PLS scheme.

3. Research Method

The subject of this research is IFIs in Yogyakarta Special Region, Indonesia. The reasons for choosing this province is because it has market share portion which is much higher than the national level. The Regional Head of Financial Services Authority (FSA) said that Islamic banks market share for Yogyakarta had reached 9% while the national level was still below 5% (Kelana, 2015). In addition, Nugraha (2016) reported that the growth of Islamic bank in Yogyakarta was twice that in national level with the 4.8 trillion rupiahs of total assets, 3.9 trillion rupiahs of financing and 3.1 trillion rupiahs of third party fund. This indicates that Yogyakarta is very conducive with the development of Islamic banks.

When this research was undertaken, there were 11 Islamic Commercial Bank (ICB), 1 Islamic unit of conventional bank and 11 Islamic Rural Banks (IRB) operate in Yogyakarta. All these banks are under supervision of the FSA. Besides these types of financial institutions, there is Islamic micro finance type of institutions namely Baitul Maal wat Tamwil (BMT) which are under supervision of Cooperation Ministry. When this research was undertaken, there were 80 BMTs in Yogyakarta.

For this research, Shariah Unit of conventional bank is not included because of it does not have full control of its bank. The operation of this type of bank depends on its parent company and less opportunity to have its own innovation as in the full pledge IFIs. This research took one Islamic commercial bank, two rural banks and two BMTs as research object. It was initially to include another Islamic commercial bank, but the process failed because of there was a change of its regional branch. All research objects were the influential IFIs in Yogyakarta where other players refer to them for benchmarking. The ICB is the biggest Islamic commercial bank in Yogyakarta with some branches and already been established for 17 years. IRB 1 is the fastest growing Islamic Rural Bank with 11 years in operation. The Director of this IRB was the Chairman of Yogyakarta Islamic Bank Association. IRB 2 is the oldest Islamic Rural Bank in Yogyakarta and still show good performance. BMT 1 is the fastest growing Islamic Micro
Finance in Yogyakarta with 25 billion assets only in five years. This BMT is established by one of the biggest Islamic private university in this province. BMT 2 is the biggest Islamic microfinance in Yogyakarta with asset reaching 100 billion rupiahs, which is bigger than asset in most Islamic rural bank in Yogyakarta.

Every Director/Head Manager of the IFIs was sent a letter with research synopsis and list of probable questions. After being agreed, the interviews were then undertaken in the interviewee’s office. Two interviewees were Directors of IRBs; one was Regional Head Manager of an ICB; one was Manager of BMT; and the other one was head of R&D unit of BMT. The interviews were undertaken between 27th of June until 27th of July 2016 and all of them were recorded and transcribed. Key governance issues identified in this study are financing duration, contract approval, contractual cost, basis of sharing, timing for paying instalment, bad financing management, customer empowerment and shariah supervision. To understand the research object better, it was also investigated information about the level of financing for PLS scheme; motivation in using PLS scheme; and Government regulation on the PLS financing.

4. Findings and Discussions
4.1 Level of Financing for PLS scheme

The five IFIs in this study have varied portions of PLS based financing. The highest is 60% and the lowest is 10%. Although very variatif, there is a pattern that IFIs which is older in terms of age tend to have higher portion compared to those which are relatively new. 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%. This indicates that an IFI might need time to learn how to manage PLS financing before using it in greater scale. During interview, it was found that newly operating IFIs have increasing portion of PLS financing. This is because they start with lower portion of PLS financing. On the other hand those which are relatively old, tend to be standstill because they have already had high portion of PLS financing.

Looking at this pattern, there is a possibility in national level that the decrease in PLS financing during the period of 2008-2013 as shown in Table 2 before is because the increase number of new Islamic banks. In this period, the new banks prefer to use less risky type of financing such as *Murabahah* sales and purchase contract. Meanwhile, the increased trend from
29.1% to 37.1% for the period of 2013-2016 could be explained that the new banks had already had better knowledge in managing PLS financing. This in turn made them confidence to use more PLS scheme.

4.2. IFI motivation and Government regulation of the use of PLS financing

There is no single motivation of the IFIs using PLS financing. Based on the fieldwork interviews, motivations in using PLS financing can be classified into two: scholar driven and customer driven. During interview, it was found that the interaction with scholars who educate Islamic bank has driven the bank to use more PLS financing:

... to be honest, at the early establishment, our problem was that the image that Islamic bank is identical with Murabahah ... at that time it was only us here and no references that can support these practices. 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. Although in practice, Murabahah, let say we buy hand phone, I use purchasing contract then gave it to my brother, that's valid. But that's not inventory or working capital added with labour cos. These [supplies] cannot use Murabahah. So since then, we had commitment to use this type of contract. (Interviewee IRB 2)

The manager of BMT with five years old in operation gave her answer about the trend and the reason for using PLS financing in her institution:

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)

This indicates that the increased in PLS financing is because there is an increased demand from customers for cash in their business. This practice follows the theory of how Islamic bank works. In theory, customers as business partner can receive cash under Mudharabah and Musyarakah contract and have flexibility in using it for the agreed project. Under Murabahah, bank provides goods to be sold to customers. Therefore the more the customer needs financing in form of cash for their business, the more PLS financing will be used.

A Director of Islamic rural bank added further that that the reason for using PLS is because they can not use Murabahah scheme:

There are some reasons why we use profit sharing financing... perhaps it is much more because we can not use Murabahah. Not because the profit sharing is more profitable than Murabahah. (Interviewee IRB 1)
The Director of Islamic rural bank explained that although they prefer to use Murabahah, the FSA regulation works well to prevent them from using it. Therefore, they use PLS scheme just because it is the only suitable type of financing for the project proposed by their customers:

"... Many customers ask for working capital or to finance a project with Work Order Letter (SKP). In Murabahah, the regulation is so detail that bank gives goods. Or if it uses Wakala, it should be done before Murabahah. Wakala is only done to buy listed items,... obligation to pay is at the bank side or who order wakalah, but it should be done before Murabahah. In a project with lots of items, it is impossible off course to buy goods by using third party. According to us, this cannot be done through Murabahah. Perhaps... we are forced to use Musyarakah or Mudharabah. This is why we use Mudharabah a lot, because the proper contract is not Murabahah, Ijarah nor others, but Musyarakah and Mudarabah, profit sharing system. (Interviewee IRB 1)"

This view shows that basically they try to avoid PLS contract if they can, and just use it when it is not possible to use Murabahah. This practice confirms distortion in Islamic banks as pointed by Haniffa and Hudaib (2010) that there is a shift to secular paradigms in competing with conventional banks. However, when the researcher probed further the reasons for avoiding PLS scheme, the Director pointed at the regulation issued by Financial Services Authority (OJK). He said that the regulation is stricter for PLS based financing than for sales based or rent based financing in terms provision for loan losses (PPAP) treatment:

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%. ... Then in the Debitur Information System, the customer will be under category of collectibility 3, which means the customer’s performance is not good. When he or she wants to go for new financing in other bank, then he or she will be recorded in the system as “substandard” although just not paying for a few days. If he or she proposes new financing, other banks will avoid him or her (Interviewee IRB 1)

In more detail, Director of the other IRB expressed similar explanation:

In Murabahah three times, if three times no instalment, then the fourth is “substandard”. But in Musyarakah, once you do not pay can go to “doubtful” because of less than 30% [payment]. The calculation, if it is more than 80% is considered current, both principal and profit... if it is between 80% to 30% that’s “substandard”. If it is 30% for less than three times falls into “doubtful” category. If it is 30% for more than three times, that will go immediately to “Loss”. If the “doubtful” category become “loss”, that could be normal. But if the payment is at the percentage 75, 70 or 60, than this becomes our burden as it is “substandard”. We with the regulation... in that, we are annoyed (Interviewee IRB 2)
The other unfavourable regulation on PLS financing found during interview was about rescheduling frequency. Unlike other schemes, in PLS scheme, bank is only allowed to do rescheduling for one time only: 

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”. In fact according to me...... We have experience of financing a civil servant who initially had a personal business when he was a Headteacher. But when he moved to other school, he had no more time to manage his business. The business when bankrupt. So when the business stopped, the profit sharing instalment was destroyed. However, he committed to pay back the principal from his salary while we did not count the margin. But... this is considered as “loss” category. (Interviewee IRB 2)

Explicitly during the interview, a Director of Islamic rural bank said that PLS financing is the second option after Murabahah due to the tight regulation besides the nature of profit sharing financing which is riskier: 

The effect is, then people will tend to force to use Murabahah and avoiding Musyarakah. We do not talk about the profit yet, if it is Murabah, the margin is feasible, but Musyarakah, not yet from the business perspective. From the logic of revenue, Murabahah is more certain than Musyarakah... So many banks, not avoiding right...the second option after Murabahah (interviewee IRB 1)

Problems with the provision and rescheduling treatment do not appear in the BMTs type of IFI. This is because BMT is not subject to FSA regulation but subject to Cooperation Ministry regulation which is very loose.

4.3. Governance Practices of PLS financing in Achieving socio-economic justice

Governance process in providing and managing PLS financing includes a number of decisions to be considered. Some issues are very technical and some others are related to the extend to which the IFIs can contribute to the achieving of socio-economic justice. These include decisions on financing duration, contract approval, contractual cost, basis of sharing, bad financing management, customer’s empowerment, and shariah compliance.

a. Financing duration

All IFIs in this study said that maximum duration for PLS based financing is three years. Even the commercial bank with more resources also employs three years maximum policy. In this Bank, the policy for Mudharabah scheme is yearly basis although can be extended:

For working capital, our regulation is three years. If we use Mudharabah, it’s yearly basis. But it can be extended (Interviewee ICB).
This is very different from the practices in Murabahah which can be up to 10 or 15 years. 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. This condition has been reminded by Dar and Presley (2000) that there is imbalance between customer's management of PLS project and the IFI's control of risk. They said that unless this imbalance can be removed, the IFIs will prefer to use sale and purchase Murabahah contract.

b. Contract approval
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:

At the early stage, after knowing the number, it's just the same like in Murabahah. We do initial interview, we do confirmation, on the spot visit to his or her house, to the business location, we do crosschecking about his or her character to the internal business or to anybody who knows him or her. So feasibility analysis or 5Cs, we do the same process (Interviewee IRB 1).

One interviewee explicitly said that character aspect is the most crucial for her. Therefore, for customers with new business, IFIs tend not to use PLS scheme:

At least character is our guidance. If there is an abuse later on, this will be very disturbing... We have to know its turnover. Does it run well or is it new? If it is new we are not brave enough to go for profit sharing scheme (Interviewee IRB 2).

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. In addition, prior to the use of PLS scheme, it was found that the process of selecting customer, is much tighter in this type of 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. This collateral is used to anticipate if customer does not meet his or her obligation to IFIs.

c. Contractual cost
Most of IFIs in this study charged customers for contractual costs such as administrative cost, notary cost, stamps and insurance. A Manager of one BMT explained as follows:

Our administration is only 0.75%. If the financing only one million rupiahs, the one making to notary is only twenty thousand rupiahs, then two or three stamps which are only ten thousand rupiahs, then insurance which is managed by venture BMT. The venture BMT is in collaboration with PBMT
[Association of BMT]. This covers two conditions, the person passes away or the damages because of fire. (Interviewee BMT 2)

In terms of administrative cost, it was found an IFI with higher level of awareness of shariah issues had lower 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)

This indicates that the more careful an IFI interprets shariah guidance, the less it takes advantage from contractual costs which is a common practice in conventional banks. But for the IFIs which takes loose interpretation of shariah guidance, will act almost similar with conventional banks on the contractual costs.

d. Basis of sharing

During the fieldwork, it was found that in general, the IFIs use revenue (gross profit) rather than net profit as the basis for sharing. The main consideration is because the revenue sharing contains lower risk for the IFIs:

[During the approval process] We bargain on how much revenue that he or she receives every month, … then from the sales, the easiest and the safest, we use revenue sharing. If it is net profit sharing, we may then have difficulties on the administrative cost and others, which can be very elastic. But if it is revenue, we just see sales [gross profit]. (Interviewee IRB 2)

In different interview, It was found that Islamic rural bank and Islamic micro finance use both net profit sharing and gross profit sharing. The Director of one IRB explained that the choice of the basis is based on customer’s type of business:

Net profit…. We tend (to use it) if the customer has lots of items. We combine it then we get profit sharing. Like in retail, lots of goods, then we have costs. We also have gross profit sharing like our financing to BMT, monthly revenue before deducted with costs (Interviewee IRB 1)

For IFIs which use net profit sharing, they do often experience the fact of not receiving profit as expected because of high costs:

We often do not receive significant sharing because from the net profit sharing, for example this month, it has high costs. For Musyararah, ideally, BMT involves in the business [decisions]. But we do not get involved. This is the weaknesses. So sometimes, the customers do not report the real one, so the costs…. the point is to make BMT receives small (Interviewee BMT 1)
This evidence tells that some 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. However, as it gives opportunity to use both net profit sharing or revenue sharing, this promotes better socio-economic objective in fulfilling public needs.

e. Timing for paying principal and profit sharing

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:

... in certain times, raw materials are cheap, then he or she keeps buying it in large amount. Meanwhile customers cannot have routine monthly cash inflow. For instance, credit sales type of business. It needs time for paying back... So we will accumulate it in the month where he or she will receive a lot of money. Property is like that sometimes. If we use Musyarakah for property, usually the money that he or she receives will be used for investment first, then he or she receives the result after selling it. But, the customer should make a schedule about in which month the approximate revenue will be collected. For example, in two years financing, within [the first] six months he or she only pays for profit sharing. After six months until two years, he or she pays profit sharing plus the principal as scheduled. (Interviewee IRB 2).

This shows that PLS based financing does offer 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.

f. Handling of bad financing

During fieldwork interview, it was found that the IFIs used systematic way in handling bad financing based on what causes the problem. There are two main causes of bad financing. These are cyclical and structural as explained by the Regional Manager of an ICB:

When there is a problem with financing to customer, we usually identify whether it is cyclical or structural. If it is cyclical, we help in terms of instalment pattern because it can recover again. But usually, certain cyclical problems had been anticipated from the beginning. We usually asked for reserve, reserve for one instalment based on customer’s projection. What for...? When we find cyclical problems, this can be anticipated. If the cyclical occurs for two or three times because of something happened, then it is considered as temporary. For this, we usually try to make that the
previous pattern of instalment to be divided into two months or we divide into three months until he or she got recovered and then get back to collectability [current]. The second one, the structural causes, we usually do mapping on it. If he or she has good character, strong going concern which means have strong possibility to continue the business and the economic sector is also potential with good prospect, we usually do restructuring. In the restructuring we can extend the time and we can change the instalment pattern which can be small that we adjust according to his or her cashflow. This can be bigger [later], according to the condition of the cashflow. But if we see that we do not get one of the three aspects to be fulfilled, we usually take exit strategy. We may ask the customer to sell voluntarily his or her asset. This can be partial or all. Then, the second one if we are dealing with the person who is not cooperative, we usually go to the court for auction. ....What for.? We have to take a good care of trust from people who has deposited their fund to us. We need to recover soon because if the financing customer is bad we got double "jab". Two punches, the first our revenue is not well, the second we incur cost [provision for bad debt]. Got hit twice! (interviewee ICB)

The amount of non-performing financing (NPF) among IFIs is varied. Some are big and some others are small. In one BMT, the NPF for PLS financing is lower than NPF for selling and purchasing scheme. The reason for this is because the portion is still small and the restructuring policy. All IFIs were also found to anticipate problems through the use of insurance which cover life and fire accident.

In PLS financing, the IFIs in the survey do not charge penalty in terms of additional payment when there is delay. This is different from what commonly practiced in Murabahah contract where the penalty will be charged but go for social fund. As expressed by one of the interviewees when being asked about penalty for payment delay:

None! We do not charge penalty at all. If it is late in the same month, there is no penalty. It goes to the next month, there is no penalty as well. But we intensify efforts to remind him or her. That's why, we do survey first, to see our partner. We use personal approach, not business approach. We ask 'why is it like this?" That's why we always ask our partner to communicate immediately when the business going down. (Interviewee, BMT 1)

This is obviously different from conventional banks where delay payment will automatically add revenue interest for the bank. On the side of conventional bank’s customer, the delay means increasing interest cost charged by the conventional banks to them which in turn will create more burden. 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.
g. Customers’ Empowerment

Based on fieldwork interview, it was identified that there are efforts by IFIs to empower their financing customers. One IFI with 22 years age seems already had a comprehensive approach in empowering its customers covering small scale customers and big scale customers:

We can share here PLC, product lifecycle. We have that kind of portfolio. This is what we mean with empowering. The input can be various characters such as labourer carrie, porter, moving seller, and pedicab driver. Those in this category are under baitul maal, social function, CSR if we want to say. Then we have partner at the Tamwil [business] category. For tamwil, have to do business survey. (Interviewee BMT 2).

There are varities of empowerment activities that have been undertaken by the IFIs. These cover religious activities, management and business training and collaboration. Based on the fieldwork interview, the costs incurred for that activities used the IFIs money and not charged to the customers. Manager of a BMT which has been operating for five years explained as follows:

We make routine meeting with our partners. At this early time we do religious supports. Now we have twice in a week program of learning how to read quran for those in traditional market. It is financed by us, we provide Cleric, so learning how to read qur’an while selling. Our expectation is to free them from quranic illiterate. Then later, after the group of the customers is solid, we plan to provide training for them such as financial management, marketing and product development. (Interviewee BMT 1)

During the fieldwork interview, a manager of an Islamic commercial bank informed that they have routinely visited their customers. During the visits, they give consultation on strategy improvement or improving their human resources quality:

Internally, we visit them every three months. It’s a must, both to them who are in “current” [financing] category or “non-current” categories. For those under “non-current” categories will be more frequent, for those under current category has minimum one visit for every three months. If during the visit, there is an indication [of problem], with marketing for instance, we always give suggestion .. alternative strategies that might increase sales or provide softskills training for their human resources. For instance, BMT that we finance, are very active asking us to be trainer for the internal training for their employees. They want to have human resource whose quality is the same as the bank. So, how the selling skills in marketing, how to early screening for their potential customers, they want to be better than before. In that, collaboration with bank is something which is positive that they can get. (Interviewee ICB)

Similar efforts have also been done by an established Islamic rural bank through activities provided for their partners:

For us, in Ramadhan moments, we tend to use it for improving religious spiritual. Usually we have moving Tarawih night prayers. We go and meet traders communities especially those identified still using conventional financial institutions. Other activity is to provide trainer to motivate, motivation training for our customers. Usually we invite Jamil Azzaini [Jakarta] or Mr Yanto from STIMIK
The Musyarakah type actually allows the bank to get involved in the business management. However, during the fieldworks, it was found in all IFIs that 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.

h. Shariah compliance supervision

Among Muslim society in Indonesia, there had been quite a lot of criticisms by the public that Islamic Financial institution is just the same with conventional bank where the difference is only on using Arabic terms for their contract. During the fieldwork interview, it was found that shariah supervision is not only undertaken by Shariah Supervisory Board, but also by the FSA. One issue that becomes their concern is IFI’s transaction with non-Islamic financial institutions, like transaction between Islamic Bank with conventional cooperations or groups of community. This issue is raised because there were concerns that Islamic bank financed a group of community under PLS contract but then the group lend the money and take profit based on interest from their members. Responding to this matter, the Manager of one commercial bank stated as follows:

Business to Business transaction related to non-shariah institution was at the special attention of OJK [FSA]. And OJK asked us and took sampling by them that the contract with end user should use shariah basis. So, we did being asked by [our] management to have onside monitoring management. So with certain position of financing with our cooperation partner, we do sampling and ensure that the contract is indeed shariah. (Interviewee BUS)

Based on the fieldwork interview, shariah concerns are not only about the IFIs but also their customers:

Shariah compliance from the partner’s side... First, honesty of financial turnover. At the beginning, it needs honesty on the usage of fund. When he or she proposes funding, he or she must be really honest that the fund will be used to finance business. Not because he or she just want to have cash [for personal use], then say it for business. Second, honesty in making financial report. This is important. Sometimes, because it is not recorded, because this is from SMEs [Small Medium Enterprises] which do not usually record transactions, then he or she just guessing. Yes..., this is our homework. In the future we should be often accompanying our partner to produce financial report. Then, the third honesty... when she or she has already had profit to share, he or she postpone the
payment until the end of contract, or think that because the profit projection is only "that much", so if got more profit, there is no need to share the excess. That's the compliance issues from customer's side... From the BMT side... yes... to be consistent with the agreed portion of profit sharing. There should be no more using indicated percentage, but real portion as contributed by the BMT. We, to our partner, if it is Musyarakah, we are happy to receive [low] if our partner's business is going down. (Interviewee BMT 1)

From the above interview, it can be inferred that 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. This situation in one hand has directed some IFIs with less concern with shariah aspect just to use indicaticated 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.

5. Conclusion and suggestion for further study

This study investigates governance practice of PLS financing in Islamic financial institutions in Yogyakarta, Indonesia. During fieldwork interviews, it was found that 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. This means that the IFIs in any way will prioritise to use the Murahahah cost-plus mark-up contract which has a lot of similarity with interests in conventional bank. This practice confirms distortion in Islamic banks as pointed by Haniffa and Hudaib (2010). But this study also found that the distortion is not only because of the pragmatic attitude of IFIs player to compete with conventional banks, but also because Government regulation which is much tighter for PLS type of financing in terms of provision and rescheduling treatment and problems with customer's honesty.

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. For further study,
there is a need to consider using questionnaire survey to all IFIs in Yogyakarta; interviewing regulators and customers as source of information; and extending the study at national level.

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