

# Improving Sharia Risk Compliance: Proposing Daily Index for *Mudharaba* Contract in Islamic Banks in Indonesia

*Laode Hasahur<sup>a</sup>, Anita Priantina<sup>b</sup>, Dewi Febrian<sup>c</sup>*

<sup>a</sup> IT Consultant, Collega Inti Pratama, Ltd

<sup>b</sup> Department of Islamic Economics, Tazkia University College of Islamic Economics, anitatazkia@yahoo.com

<sup>c</sup> Department of Islamic Accounting, Tazkia University College of Islamic Economics, dewifebritazkia@yahoo.com

## Abstract

**Objective** – The objective of this paper is to analyze the profit distribution method applied in Islamic banks in Indonesia and to propose better method in order to improve sharia risk compliance.

**Methods** – Employing a descriptive quantitative method and literature review. This paper evaluate weaknesses of the current profit distribution method and proposes daily revenue index to solve the problems arising from using current method which is unfairness between bank and customers.

**Results** – By the two current profit distribution methods which use monthly revenue index calculated only at the end of the month, there are potential injustices occur. Therefore, instead of using monthly index, daily index is proposed. There are two steps in calculating profit distribution by using daily revenue index: (1) Accumulating Source of Fund (SoF), Reserve Requirement (RR), and Source of Fund after Reserve Requirement (SoFaRR), and (2) Determining Average Financing (AF), Revenue Index (RI), Cost Index (CI), Revenue Sharing Index (RSI), and Profit Sharing Index (PSI).

**Conclusion** - Daily revenue index will solve the unfairness problems arise from current profit distribution method applied in Islamic banks. Daily revenue index is also applicable if Islamic banks apply profit and loss sharing instead of revenue sharing.

Keywords : Islamic Banking, *Mudharaba*, Revenue Sharing, Profit and Loss Sharing

## Abstrak

**Tujuan** - Tujuan dari paper ini adalah untuk menganalisis metode distribusi laba yang diterapkan di bank-bank syariah di Indonesia dan mengusulkan metode baru yang dapat menjaga kepatuhan syariah secara lebih baik.

**Metode** – Penelitian ini menggunakan metode pemodelan deskriptif kuantitatif dan kajian pustaka. Penelitian ini melakukan evaluasi pada metode pembagian laba yang berlaku saat ini dan mengusulkan indeks pendapatan harian untuk memecahkan masalah yang timbul dari penggunaan metode yang sekarang yaitu kemungkinan terjadinya ketidakadilan antara bank dan nasabah.

**Hasil** – Dengan metode penghitungan laba saat ini yang menggunakan indeks pendapatan bulanan yang dihitung hanya pada setiap akhir bulan, ada potensi terjadinya ketidakadilan antara nasabah dan bank. Dengan demikian, diusulkanlah penggunaan indeks pendapatan harian. Langkah dalam menghitung pembagian laba dengan menggunakan indeks pendapatan harian adalah sebagai berikut: (1) Menghitung Sumber Dana (SoF), Giro Wajib Minimum (RR), dan Sumber Dana setelah Giro Wajib Minimum (SoFaRR), dan (2) Menentukan Pembiayaan Rata-rata (AF), Indeks Pendapatan (RI), Indeks Biaya (CI), Indeks Bagi Hasil Pendapatan (RSI), dan Indeks Bagi Untung Rugi (PSI).

**Kesimpulan** – Indeks pendapatan harian akan dapat menyelesaikan masalah yang muncul dari penggunaan metode penghitungan laba yang digunakan oleh bank syariah saat ini. Indeks pendapatan harian juga akan dapat digunakan jika bank menggunakan sistem bagi hasil.

Keywords : Islamic Banking, *Mudharaba*, Revenue Sharing, Profit and Loss Sharing

## 1. Introduction

The first Islamic bank in Indonesia was established in 1992. By 2012, there are 11 full pledged Islamic Banks, 23 Islamic Business Units and 154 Islamic Rural Banks. The development of Islamic banks is enhanced by the uniqueness of its system compared to conventional one.

In terms of financing, Islamic banks offer *musharakah*<sup>1</sup> (joint venture partnership), *mudharabah*<sup>2</sup> (trustee partnership), *murabahah*<sup>3</sup>, and other modes of financing. This mode of financing is partnership methods that have long been known and practiced even before Islam. In 2012, the portfolio is still dominated by *murabahah* by 42.42% while *musharaka* is 14.45%, *qardh*<sup>4</sup> is 10.61%, and *mudharaba* is only 8.26%. One of the dominant causes is risk aversion (Ascarya, 2010).

In spite of its unpopularity, *mudharaba* has some advantages, even when it is compared to conventional interest rate system. Profit and loss sharing (PLS) has proven to outperform interest system in terms of efficiency, fairness, and stability. Furthermore, at macro scale, PLS returns can be used as an alternative to interest rates as a monetary policy instrument (Ascarya, 2008). In *mudharaba* scheme, there are two parties involved; *shahibul maal* and *mudharib*. In terms of banking, *shahibul maal* is the financier and *mudharib* is the entrepreneur. Therefore, bank will act as the financier in the financing

<sup>1</sup> A financing technique adopted by Islamic banks. It is an agreement under which the Islamic bank provides funds which are mingled with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions (Khan, 2003: 136-137).

<sup>2</sup> A form of business contract in which one party contributes capital and the other personal effort. The financier is known as *rabb al-mal* and the worker or entrepreneur as *mudharib*. The proportionate share in profit is determined by mutual consent. But the loss is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labor. As a financing technique adopted by Islamic banks, it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared in pre-agreed ratios, and loss, if any, unless caused by the negligence or violation of the terms of the contract by the *mudharib*, is borne by the Islamic bank. Ultimately, the bank passes on the loss to the depositors (Khan, 2003: 129).

<sup>3</sup> The sales of goods with agreement upon profit mark up on the cost. In its original concept it was a cash transaction with the intention of sparing the buyer the trouble of investigating the genuineness of the price. The buyer would offer to sell the product at a certain price over and above his purchase price. But it has been developed into a financing technique by the present day Islamic banks. As practiced by the Islamic banks, the *murabahah* sale is of two types. In the first type, the Islamic bank purchases the goods and makes them available for sale without any prior promise from a customer to purchase it. In the second type, the Islamic bank purchases the goods ordered by a customer from a third party and then sells these goods to the same customer. In the latter case, the Islamic bank purchases the goods only after the customer has made a promise to purchase them from the bank (Khan, 2003: 26).

<sup>4</sup> Literally: To cut, to sever. Technically: Loan of *mithl* articles (such as money) with the stipulation to return its like in the future. It is a general term for monetary loans without a deadline for repayment (Khan, 2003: 150)

product and will act as the entrepreneur in the funding product. *Shahibul maal* and *financier* do not act as creditor and debtor, but as partners working together to make profit. Originally, *mudharaba* is partnership based on profit and loss sharing. In Indonesia, currently revenue sharing is allowed by Fatwa of Dewan Syariah Nasional - Majelis Ulama Indonesia (DSN-MUI “National Sharia Board – Indonesian Council of Ulama) Number 24 year 2002. By revenue sharing, *mudharaba* deposit is now the most favored product among all funding products, especially one month *mudharaba* time deposit (Bank Indonesia, 2012).

There is one issue in current revenue distribution method as it is currently conducted only at the end of the month. If the customer deposits the money at the beginning of the month, then there will not be any problem arises. But, if the money is deposited not at the beginning of the month, for example in the middle of the month; there are two possibilities for the profit distribution. There are two optional methods that banks can use in this case. 1) First is to calculate the revenue sharing at the end of the first month using that month’s revenue index, 2) Second option is to calculate the revenue sharing twice; at the end of the first month with the first month’s revenue index, and the rest will be calculated at the end of the second month with the second month’s revenue index. Using the first method, there is potential injustice, for the bank when the actual revenue is lower at the upcoming month and vice versa. Using the second method, the customers will get the revenue sharing after the maturity date of their deposit. This may not be favorable for the customers.

The objective of this paper is to analyze the profit distribution method applied in Islamic banks in Indonesia. Related to the unfairness problems occur from current profit distribution method, this paper proposes better method. It is expected that the proposed method will improve the sharia risk compliance.

## 2. Methodology

This study employs a descriptive quantitative method. This paper evaluate weaknesses of the current profit distribution method and proposes better method to solve the problems arising from using current method which is unfairness between bank and customers. Literature review is also implemented to strengthen the concepts used as the background for the discussion and to strengthen the result from the discussion.

### 2.1. Principles in Islamic Financial Transaction

Based on its character, the principles of Islamic Financial Transaction are as follow (IAI, 2011):

1. The transaction is only carried out on the basis of mutual understanding and mutual benefit, and does not contain any element of injustice. This is as stated in an Nisaa: 29:

“O ye who believe! eat not up your property among yourselves In vanities: but let there be amongst you traffic and trade by mutual good-will...”

2. The principle of freedom in transaction is recognized under the condition that the traded object is lawful and good (*thayib*<sup>5</sup>). This principle is in line with the following legal maxim:

الأَصْلُ فِي الْمُعَامَلَاتِ الْإِبَاحَةُ إِلَّا أَنْ يَدُلَّ دَلِيلٌ عَلَى تَحْرِيمِهَا.

“Basically, all forms of *mu'amalat* are permitted unless there is proof that forbids it.”

3. Money has to be treated as a medium of exchange and unit of account, not as a commodity;
4. *Riba*<sup>6</sup> is prohibited, as stated in Al Baqara 275:

“...but Allah hath Permitted trade and forbidden usury...”

<sup>5</sup> Literally: Good things, good and pure things. Technically: Used in the Qur'an for the consumer's goods provided to human beings. The concept carries with it man's responsibilities to God and other human beings for the use of these good things. It excludes the haram goods from its domain (Khan, 2003: 182-183)

<sup>6</sup> Literally: An excess or increase. Technically: An increase which in a loan transaction accrues to the lender over time without giving an equivalent counter-value or recompense ('iwad) in return to the borrower (Khan, 2003: 157).

5. *Maysir*<sup>7</sup> is prohibited.
6. *Gharar*<sup>8</sup> is prohibited,
7. Principle of time value of money is prohibited<sup>9</sup>.
8. Transactions carried out under clear clauses of agreement
9. *Najasy*<sup>10</sup> and *Ikhtikar*<sup>11</sup> are prohibited.
10. Bribery (*riswah*) is prohibited.

## 2.2. Profit Distribution: Profit and Loss Sharing (PLS) and Revenue Sharing

Besides explaining the prohibition of *riba*, literatures on Islamic finance is dominated by the explanation of the advantages of Profit and Loss Sharing (PLS). However, the percentage of PLS practice worldwide is not significant. There are reasons for that. Dar and Presley (2000: 3-4) concludes 7 reasons: 1) PLS Contracts are inherently vulnerable to agency problems; 2) PLS contracts require well defined property rights to function efficiently; 3) Islamic banks face severe competition from long established conventional banks and other financial institutions; 4) The restrictive role of shareholders (investors) in management; 5) equity financing is not feasible for funding short term projects compared to high degree of risk; 6) unfair treatment in taxation; and 7) Secondary markets for trading in Islamic financial instruments are non-existent.

Currently, revenue sharing is allowed by Fatwa of DSN-MUI Number 24 year 2002. This fatwa was issued under consideration that Islamic banks are still in early development stage. People are deemed as not yet ready to implement the true profit and loss sharing. For customers, deposit under profit and loss sharing saving/ deposit may not

<sup>7</sup> Literally: An ancient Arabian game of chance played with arrows without heads and feathering for stakes of slaughtered and quartered camels. Technically: It came to be identified for all types of gambling (Khan, 2003: 118).

<sup>8</sup> Literally: Hazard, chance or risk (Khan, 2003: 66). Technically it refers to every transaction that could potentially hurt either party as an element of uncertainty, manipulation and exploitation of information and the lack of certainty in the execution of the contract.

<sup>9</sup> because the business activities associated with the risks inherent in the business activities in accordance with the principle of no gain without accompanying risk

<sup>10</sup> Literally: Concealment, rousing and chasing the game for the purpose of snaring it. Technically: In business transactions, this term means to demand the sale of an article of merchandise for more than its price, not meaning to purchase but only to ensnare the innocent buyer (Khan, 2003: 179).

<sup>11</sup> Hoarding of commodities of any kind, particularly foodstuff, with a view to create artificial scarcity and rise in price (Khan, 2003:83).

be interesting since there is possibility of loss bearing. For banks, to finance under profit and loss sharing may not be interesting as well since there is possibility of moral hazard so the customer may tend to disclose more cost and therefore less revenue or less profit generated. In conclusion, revenue sharing is recommended compared to profit sharing in order to create more competitive playing field for Islamic banks.

Under profit and loss sharing, it is profit that will be distributed. Profit is resulted after deducting gross profit by cost related to *mudharabah* practice. Under revenue sharing, it is gross profit that will be distributed between *shahibul maal* and *mudharib*. Gross profit is revenue deducted by cost of product or services. (Sharia Financial Accounting Standard No. 105). By considering the benefit and current condition of Islamic Banks, revenue sharing is more recommended by Fatwa of DSN MUI No. 003 year 2000.

### *2.3. Profit Distribution Basic Principles*

There are some basic principles in profit distribution:

1. Bank share the cash revenue earned from its earnings asset.

Earning Assets itself consist primarily from third party fund (after set aside for reserve requirement), but by discretion it may also come from the capital of the bank.

2. Revenue shared between the bank and the investor is proportional to the contribution of funds (capital).

Reserve requirements are the primary reserve (Cash and Demand Deposit made at the central bank) and secondary reserve (Bank Indonesia Sharia Certificates: SBIS) is also included. If SBIS is included in the secondary reserve, then the component of earning assets only include; deposits with banks, financing, and other securities.

3. Revenue shared between the bank and the investors (financiers) is proportional to the ratio (*nisbah*) agreed at the beginning of the contract.

In the profit distribution system, the revenue should be distributed on the cash basis, but in the presentation of balance sheets and income statement, it is allowed to use the accrual method.

### 3. Results and Discussions

#### 3.1. Profit Distribution: Current Method

There are two alternatives to calculate distributed revenue to the *shahibul maal* and the *mudharib* in Islamic banks:

1. The first is calculating the revenue sharing at the end of the first month using that month's revenue index,
2. The second option is calculating the revenue sharing twice; at the end of the first month with the first month's revenue index and the rest will be calculated at the end of the second month with the second month's revenue index.

There are some potential problems in applying this method. The following illustration will make it clear.

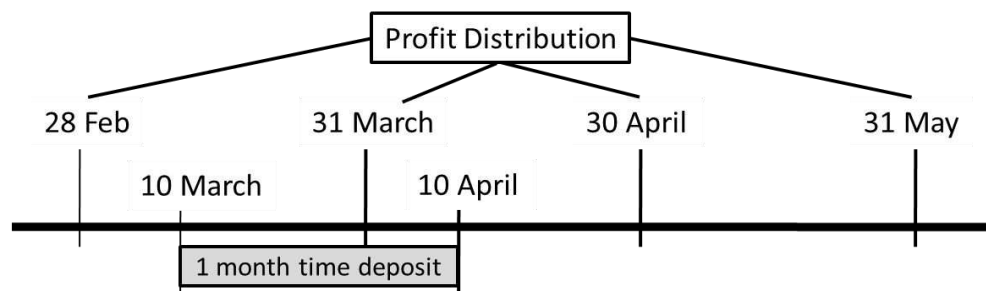


Fig. 1 Profit Distribution: Current Method

Based on the illustration above, the *mudharaba* deposit period is one month; from March 10<sup>th</sup> to April 9<sup>th</sup>. If the first method is used, March 31<sup>st</sup> will be the date to calculate the revenue sharing for the whole deposit period: 30 days. The basis of the distribution is the revenue from the investment by March 31<sup>st</sup>. If the second method is used, on March 31<sup>st</sup>, revenue will be distributed only for duration March 10<sup>th</sup> – March 31<sup>st</sup> with investment revenue on March 31<sup>st</sup> as the basis and the rest will be calculated on April 10<sup>th</sup>.

while the distribution will be done at April 31<sup>st</sup> with April's investment revenue as the distribution basis.

Each alternative has a risk. In the first option, the rate used as the basis of distribution is the expected rate. The bank as the entrepreneur is at loss if the actual rate on April is lower and vice versa; the customer is at loss if the actual rate on April is higher. In the second alternative, the rate used is actual rate, but the customer as the financier will have to wait until the end of the next month, even exceeding the maturity date.

The detail of the calculation is as follows:

1. Accumulating Source of Fund (SoF), Reserve Requirement (RR), and Source of Fund after Reserve Requirement (SoFaRR)

- a. Source of Fund

Source of Fund for financing comes from *Wadiah/Mudharabah* Demand Deposit, *Mudharabah* Time Deposit, Placement from other Bank, and Bank's Equity. After all funds (especially in multi-currency) are converted to Rupiah using daily rate, these sources of fund is totaled as consolidated fund.

- b. Reserve Requirement (RR) and Source of Fund after RR (SoFaRR)

The central bank demands all bank to keep a percentage of the banks' deposit to be hold, rather than lent out (in Islamic bank: financed out). By August 2012, the RR is 8 % in Indonesia; so 8% of third party fund cannot be financed out to customers. The same thing also goes to the third party fund in foreign exchange.

2. Determining Average Financing (AF) and Revenue Index (RI)

The indexes measured below are counted monthly. The steps are:

- a. Determining Average Financing (AF) in a month
  - b. Determining Average SoFaRR; average source of fund after holding reserve requirement in a month
  - c. Determining Average SoF; average source of fund in a month



- d. Determining Accumulated Revenue (AcR) in a month
- e. Determining Shared Revenue; since source of fund may also come from the bank's equity, to determine the revenue to be shared between the bank and the customer, the percentage of source of fund after reserve requirement (SoFaRR) over the average financing (AF) has to be calculated first. After that, then we can multiply the ratio of SoFaRR over AF to the Accumulated Revenue (AcR)
- f. Determining Revenue Sharing Index (RI), by multiplying the ratio of shared revenue over the average source of fund (ASoF) with the index factor (if let say we want to have three digit index factor, so we will have 1000 as the factor)

Commodity.....(1)  
 Payment in spot  
 Payment in deferred

### 3.2. Proposing Daily Index as the Basis for Profit Distribution

This method is applicable, even for multicurrency source of fund. Although currently, revenue sharing is applied in Indonesia, this method is also applicable for profit and loss sharing (PLS) system.

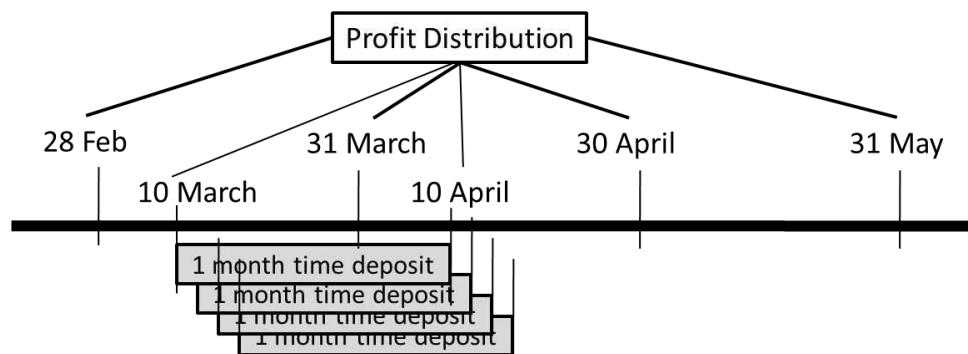


Fig. 2 Profit Distribution: Proposed Method

The detail of the calculation is explained below. The first step is similar with the current method:

1. Accumulating Source of Fund (SoF), Reserve Requirement (RR), and Source of Fund after Reserve Requirement (SoFaRR)

a. Daily Source of Fund

Source of Fund for financing comes from *Wadiah/Mudharabah* Demand Deposit, *Mudharabah* Time Deposit, Placement from other Bank, and Bank's Equity. After all funds (especially in multi-currency) are converted to Rupiah using daily rate, these sources of fund is totaled as consolidated fund.

b. Reserve Requirement (RR) and Source of Fund after RR (SoFaRR)

The central bank demands all bank to keep a percentage of the banks' deposit to be hold, rather than lent out (in Islamic bank: financed out). By August 2012, the RR is 8 % in Indonesia; so 8% of third party fund cannot be financed out to customers. The same thing also goes to the source of fund in foreign exchange.

2. Determining Average Financing (AF), Revenue Index (RI), Cost Index (CI), Revenue Sharing Index (RSI), and Profit Sharing Index (PSI)

The indexes measured below are counted monthly based on the deposit duration. The beginning date is counted from the beginning day the fund is deposited by the customer; whether it is at the beginning, the middle, or the end of the calendar date. To come up with the Revenue Index (RI), steps a-g is needed, while to calculate Profit Sharing Index (PSI), steps a-j is needed. The steps are:

- a. Determining Average Financing (AF) during the deposit period
- b. Determining Average SoFaRR; average source of fund after holding reserve requirement during the deposit period
- c. Determining Average SoF; average source of fund during the deposit period
- d. Determining Accumulated Revenue (AcR) during the deposit period
- e. Determining Shared Revenue; since source of fund may also come from the bank's equity, to determine the revenue to be shared between the bank and the customer, the percentage of source of fund after reserve requirement (SoFaRR) over the average financing (AF) has to be calculated first. After that, then we can multiply the ratio of SoFaRR over AF to the Accumulated Revenue (AcR)

- f. Determining Revenue Sharing Index (RSI), by multiplying the ratio of shared revenue over the average source of fund (ASoF) with the index factor (if let say we want to have three digit index factor, so we will have 1000 as the factor)

$$RSI = \frac{SR \times Faktor}{ASoF} \dots\dots\dots(1)$$

- g. Determining Accumulated Cost (AcC) during the deposit period
- h. Determining Shared Cost, to determine the cost to be shared between the bank and the customer, the percentage of source of fund after reserve requirement (SoFaRR) over the average financing (AF) has to be calculated first. After that, then we can multiply the ratio of SoFaRR over AF to the Accumulated Cost (AcC)

$$C = \frac{SoFaRR}{AF} \times AcC \dots\dots\dots(2)$$

- i. Determining Cost Index, by multiplying the ratio of shared cost over the average source of fund (ASoF) with the index factor

$$CI = \frac{SC \times Faktor}{ASoF} \dots\dots\dots(3)$$

- j. Determining Profit Sharing Index, by deducting cost index (CI) from the revenue sharing index (PSI):

#### 4. Conclusion

By the two current profit distribution methods which use revenue index calculated only at the end of the month, there are potential injustices occur. Using the first method, there is potential injustice for the bank when the actual revenue is lower at the upcoming month and vice versa. Using the second method, the customers will get the revenue sharing after the maturity date of their deposit which may not be favorable. This paper proposes daily revenue index to solve the problems and therefore to improve the sharia compliance, since this proposed method promote more justice and is also applicable and encourage the use of profit and loss sharing.

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