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# The Determinants of *Maqasid Shariah* Based Performance of Islamic Banks in Indonesia

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***Abstract***

*This study aims to examine the determinants of maqasid shariah based performance of Islamic banks in Indonesia. The data was extracted from the published annual audited reports of Islamic banks in Indonesia during the period 2014-2017. This research used correlation and multiple linear regression analysis to examine the proposed hypotheses. Maqasid shariah based performance was proxied by maqasid index. The proposed factors as determinants of maqasid shariah based performance are profit loss sharing financing, cost efficiency, and risk taking behavior. The results of this research revealed that profit sharing financing positively influences maqasid shariah based performance, but risk taking behavior has a negative impact. Cost efficiency does not influence maqasid shariah based performance. The implication of this finding is that Islamic banks should have commitment to realize maqasid shariah through increasing their profit loss sharing financing in the mudharabah and musharakah modes*

***Keywords:***

*Maqasid Shariah, Profit Sharing, Cost Efficiency, Risk*

## Introduction

Western economy paradigm is based on economic freedom, self-interest, maximizing profit, and market force domination (Din & Ibrahim, 2006). The implication of economic freedom puts capital owners to gain the most benefit in the economic system. Western economists have recognized that capitalist system impact on a variety of issues such as inflation and unemployment (Sukirno, 2000).

Islam offers economic concepts that put human behavior based on the spirit and norms of *Qur'an* and *Sunnah* (Misanam, Suseno, & Hendrieanto, 2008). The ideal economic system leads people to achieve the objectives of the Shariah in the happiness and well-being are essential not only in the world but also the hereafter. Therefore, the Islamic economic system is designed for the purpose of achieving economic, social, and divine in the integrated system.

Islamic banking is a product of Islamic economics which offers financial services based on the principles of Islamic law. Islamic banks as well as other Islamic business organization built to run credentials in business transactions based on the rules and principles of Islamic law (Karim, 2001).

Islamic banking has been adopted in many countries all over the world since 1973. The Dubai Islamic bank is the first Islamic commercial bank and followed by a large number of Islamic banks. Nowadays, there are more than 300 Islamic banks in 75 different countries (Alemu, 2012). Iran, Sudan, and Pakistan have entirely implemented Islamic banking system, while another countries operating in dual banking system, where Islamic banks and conventional banks coexist in a country (Metwally, 1997).

In order to understand Islamic banking, its basic values and the philosophy must be recognized and also include the objective of Islamic banking entirely. The philosophy of Islamic banking can be identified through the main objective of Islamic economic, that is to create the equal and balanced society (Dusuki, 2008). While the objectives of Islamic bank are to promote economic and social welfare beyond the conventional paradigm.

Basic values that underlie the system of Islamic banking are profit-loss sharing (PLS) principle, prohibition of *riba* (interest charge), free from *gharar* (unreasonable uncertainty), and also free *maysir* (gambling of speculation transactions). Islamic banking provides services that are based on that Islamic principles both in funding and financing activities. Investment in Islamic banking should be on the *halal* (allowed projects) to achieve the *maqasid* (goal) *al-shari'ah*.

Performance is a benchmarks of Islamic banks to determine growth and find out position in industry. Internal of banks and stakeholders such government can use it to specify regulation and carry out supervisory actions. Some appraisal methods have been used to evaluate banks' performance and formulated in certain standard such as CAMEL and CAMELS. The CAMEL method assesses performance using capital, asset quality, risk management, earning, and liquidity parameters, while market sensitivity to risk is added in the CAMELS method. However, those valuation methods only consider financial indicators as measurement of Islamic banks performance and not fully represent *maqasid shariah*.

In the Islamic finance and economics, *maqasid shari'ah* refers to the purpose of financial transactions and activities that captures circulation of wealth, transparency and fairness, and justice. The goal of wealth circulation relates to the objective of *shari'ah* (Islamic directions) macro, while the objective of justice and transparency relate to the instrument and mechanism of financial transaction. Every individual in financial transaction must be treated in the *huquq* (equal opportunity), not to be exploited, and receive the right values from an economic or financial institution. Justice itself involves rights, equality, harmony, and balance to create *maslahah* (benefit).

Some Muslim scholars have begun to conceptualize the adequate method for measuring the performance of Islamic banks. One method was developed from Abu Zahrah as carried out by Mohammed & Taib (2015) and also Mohammed *et al*. (2015) and then known as *Maqasid Index* (MI). In that model, some objectives were formulated and derived into elements and ratios. Based on the background, this paper will examine factors that determine *maqasid shariah* based performance. Some researchers found that profit loss sharing (PLS) financing, cost efficiency, and risk taking behavior are factors that affect it.

**Theoretical Review**

*Maqasid shariah* is formed from *maqasid* (purpose or objective) of *shariah* (Islamic law). The *maqasid shariah* theory was built gradually over centuries with sources of statements in the book of *ushul al-fiqh* until it was formulated in Islamic law (Lamido, 2016). Definitely, *maqasid shariah* is the ideals and goals of shariah that includes standards, criteria, values, and guidelines derived from revelation to be applied in solving humanity's problems and also as guideline in life (Laldin & Furqani, 2013).

Auda (2008) classified four dimensions of *maqasid shariah* which are level of necessity (traditional classification), scope of the rulings aiming to achieve purposes, scope of people included in purposes, and level of universality of the purposes. In the traditional classification, maqasid divide them into three level of necessity which are *daruriyyat* (necessity), *hajiyat* (convenience), and *tahsiniyat* (refinements) (Mohammed *et al*., 2015). According to Al Ghazali, necessity consists of five important elements or called as *al-daruriyat al-khams* that are *al-din* (faith), *al-nafs* (soul), *al-'aql* (intellectual), *al-nasl* (descent), and *al-maal* (wealth).

Islamic banking has objectives beyond the ordinary conventional banking in fulfilling the Allah's obligation and promoting socio-economic well-being of the society (Aliyu, 2014). The concept is comprehend and accommodated the principle of transparency through corporate governance and accountability that incorporated with global issue. *Maqasid* achievement in Islamic banking industry is indicated by bank's contribution to create social welfare, participation in alleviating poverty, and conducting socialization and education of Islamic values as guidance in economic and social life. Economic goal to maximize profit can be achieved through operational activity, while social objective through social responsibility activities.

Islamic banking system also has economic prosperity goal that extends to the level of full employment and economic growth in optimum level. Socio-economic justice can be achieved through the distribution of income and wealth is evenly distributed. The relationship between the various parties in the Islamic banking system itself is described is not a transactional relationship but as a transcendental relationship. Islamic bank prohibits *riba* and speculation. It is considered as a barrier spirit of brotherhood in Islam.

Social *mashlahah* in Islamic economic system is not limited on charity domain as *zakah*, *infaq*, *shadaqah*, and *qard al hasan*. The mechanism, indeed, can be realized through social mechanism as an integrated system in all Islamic banks products. If social *mashlahah* is well-established, there is no domination on specific product but bank must be committed to share risk with partner in risky contracts such as in *mudharabah* and *musharakah*. In its contracts, bank has authority to interfere its financed projects.

Mohammed *et al*. (2015) developed Maqasid Based Performance Evaluation Model (MPEM) to measure the performance of Islamic banks. The model used al-Imam al-Ghazali's theory of *maqasid al-shari'ah*, Ibn 'Ashur's reinterpretation, and adopted content analysis of behavioral science from Sekaran. In those model, five dimensions were used to measure maqasid shariah consists of preservation of faith (*hifdz al-din*), preservation of life (*hifdz al-nafs*), preservation of intellect (*hifdz al-'aql*), preservation of progeny (*hifdz al-nasl*), and preservation of wealth (*hifdz al-maal*). The dimensions were derived into several elements and ratios to highlight the viable measurements.

Mohammed & Taib (2015) also developed Islamic banking performance based on *maqāsid al-sharī'ah* framework in 24 selected banks with Abu Zahrah's theory. Three objectives were used in those model consists of education (*tahdhib al-fard*), justice (*iqamah al-adl*), and public interest (*maslahah*). In line with the model, performance of Islamic bank was calculated with a number of elements and ratios through weighted system to find maqāsid index (MI).

The two models above agreed to put mudharabah and musharakah contract as factors that determine maqasid based performance of Islamic banks. In the profit loss sharing contract, both owner of fund (*shahibul maal*) and organizer (*mudharib*) have opportunity to take risk in their project. No domination of *murabahah* and *ijarah* contracts indicate commitment of Islamic banks on *maqasid shariah*.

The advantages of *mudharabah* and *musharakah* financing in the development of *maqasid shariah* are: (1) Islamic banks have authority to determine the conditions of the project if compared with *murabahah* contract; and (2) on *mudharabah* and *musharakah* contracts, Islamic banks have direct contract with real market and the types of *mudharib* (organizer) can be in involved in the projects. Allocation for PLS financing determines the performance of Islamic banks due to the contract represents a commitment of Islamic banking to realize Islamic principle and *maqāsid al-sharī'ah* in their operation.

Some researchers found the impact of PLS financing on Islamic banks performance. Suhendar & Tanuatmodjo (2014) studied the effect of profit sharing financing on profitability in PT Bank Muamalat Indonesia. The result showed that profit sharing financing affect bank profitability. Rahayu *et al*. (2016) found that *mudharabah* positively affect profitability, whereas *musharakah* negatively affect profitability.

The ability of Islamic banking to manage cost exhibits effort to maintain relationship between bank and stakeholder. Cost efficiency implies how Islamic bank in which resource is optimally allocated to serve each individual or entity in the best way while minimizing waste and inefficiency. Risk taking behavior in banking is any consciously controlled behavior by bank to protect their operation and customer from disadvantage due to factors that cannot be predicted.

Many studies have documented the impact of cost efficiency on bank performance. Hussainey *et al*. (2017) found the impact of cost efficiency on Islamic banks' performance. Higher efficiency as the lower cost to income ratio was positively associated with Islamic banks' performance. Rashwan & Ehab (2016) compared efficiency between Islamic and traditional banks of 66 banks in various countries. In the study, the efficiency of Islamic banks have more influence on their performance compared to their counterparts.

Risk in the banking context is a potential event, both in anticipated or unanticipated risk which can have a negative impact on bank performance (Karim, 2007). Stakeholders have different expectations for bank. The owners or investors expect for increasing prosperity while customers or depositors for getting fair and transparent return. Therefore the regulation also aims to protect various interest due to risks have potential occurs in banking activities.

Risk is inherent in every business and the survival of business depends on how well the risk can be identified and anticipated (Baber, 2016). According to agency theory, risks can increase conflict of interests among shareholders, management, and depositors. If risk increase, the possibility for obtaining profit will be restricted. Risk management or mitigation is necessary for bank stability and public trust. The objective of risk management is not for stop risk, but to control risk.

Some studies showed the impact of risk management or risk taking behavior on bank performance. Baber (2016) reported that bank which can decreased risk success to receive higher profitability. Mollah *et al*. ( 2017) provided evidence that the governance structure of Islamic banks help them undertake higher risks and then achieve better performance.

**Research Method**

This study evaluated the annual reports of the 11 Islamic commercial banks in in the period 2014-2017. Applying panel data, research sample is taken by purposive sampling with the following criteria: (1) Islamic banks in this study are Islamic commercial banks; and (2) publishing annual reports during 2014-2017. The consolidated annual reports collected from official website of Islamic commercial banks in Indonesia.

Data will be examined using multiple regression analysis. Several classical assumptions also be analyzed before hypotheses testing. The basic model of multiple regression is used to test hypotheses as in the following model:

$$MI_{i,t} = \alpha_{i,t} + \beta_1 PSR_{i,t} + \beta_2 CIR_{i,t} + \beta_3 CRAR_{i,t} + \varepsilon$$

Table 1: The Operational Variables

| Variables | Description | Proxy |
|---|---|---|
| *Maqasid Shariah* Based Performance | Performance based on standards, criteria, values, and guidelines of Islamic law. This model was derived from 3 objectives that are *tahdhib al-fard* (educating the individual), *iqamah al-'adl* (establishing justice), and *jalb al-maslahah* (promotion of public interest) | Maqasid Index (MI) |
| Profit Sharing Financing | The proportion of profit sharing financing relative to total financing allocation. The higher percentage of the financing shows the higher implementation of *maqasid shariah* | Profit Sharing Ratio (PSR) |
| Cost Efficiency | How efficiently the Islamic bank in their operation. If the ratio raises from the one period to another period, it means that Islamic bank is being inefficient because the costs are rising higher than income | Cost Income Ratio (CIR) |
| Risk Taking Behavior | Certain regulatory of Islamic bank to maintain bank stability from probable losses or to prevent failure. If the ratio raises, it means that Islamic bank's capacity for assure risk raises also | Capital to Risk Assets Ratio (CRAR) |

Four variables are used in this study to examine proposed hypotheses. Dependent variable is *maqasid shariah* based performance that measured by using Maqasid Index (MI). Maqasid Shariah Index was measured through several steps (Mohammed & Taib, 2015). Independent variables in this study are profit sharing financing, cost efficiency, and risk taking behavior. Profit sharing financing is measured by Profit-Sharing Ratio (PSR) as the proportion of mudharabah and musharakah financing relative to total financing. Cost efficiency is measured by Cost Income Ratio (CIR) as the expenditure of operating activities on operating income. While Risk taking behavior is measured by Capital to Risk Assets Ratio (CRAR) as the proportion of capital on risk weighted assets.

**Result and Discussion**

Various contracts have impact on how performance determined in Islamic bank practices. The main difference between Islamic banks and conventional banks is in the implementation of profit loss sharing contract. Islamic banks only guarantee the repayment of the nominal value for demand deposits and savings, but do not guarantee the repayment of the nominal value for deposits. The regulatory mechanism for profit distribution of deposits depends on the performance of Islamic banks.

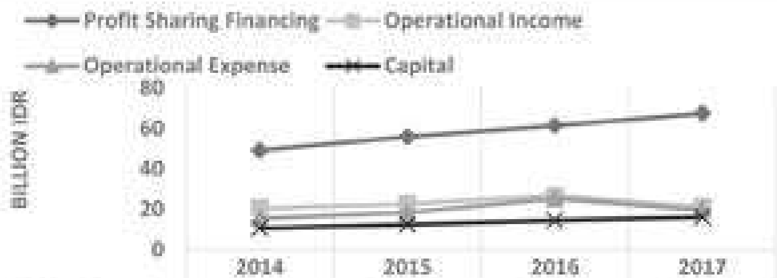
Operational system of Islamic banks based on equity system where every capital contains risk. Therefore relationship between Islamic bank and clients is based on profit and loss sharing. Shanin A. Shayan as CEO and Bond Manager of Barokat Foundation stated that "*the biggest risk facing the global Financial System is not a fall in its earning power but most importantly a loss of faith and credibility on how it works*" (Umam, 2013). Islamic banks should ensure that every transaction transparent and fair in their risks characteristics.

Islamic banks run the intermediate function in mobilize and allocate funds based in Islamic principles. Management of profit distribution is the advantage of Islamic bank that it is flexible both for third parties as well as the owners of capital (Farook *et al*., 2012). It includes profit sharing or revenue sharing and also benefit in other forms such as the payment of rent, additional profit or fee for services contract. Islamic banks contracts are based on capital participation so that moral hazard and adverse selection problem can be minimized.

Essentially, Islamic banks underlying activities based on four main principles: (1) risk-sharing to reflect the distribution of risk and return for each party in each transaction activities of Islamic banks; (2) the materiality of transactions related to real economic activity; (3) are not allowed any exploits on all parties to the transaction; and (4) the lack of funding to activities that are prohibited or forbidden (El-Hawary *et al*., 2007).

Achievement of economic goals, especially in assets and performance can not stand alone and must keep pace with the achievement of social objectives. Social mashlaha will be achieved when social welfare distributed evenly, and create social and also economic equality in the society. Islamic banks as providers of financial services institutions have a strategic role in mediating the socioeconomic functions.

Table 2: The Growth of Four Indicators




| | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| Profit Sharing Financing | 49.225 | 55.886 | 61.515 | 67.526 |
| Operational Income | 20.636 | 22.645 | 26.729 | 21.249 |
| Operational Expense | 15.543 | 18.391 | 25.391 | 19.663 |

Source: OJK, Sharia Banking Statistics, 2014-2017

Profit sharing financing as can be seen in table 2, increased to 13.53% in 2015 but fell to 10.07% in 2016 and 9.77% in 2017. Operating income showed a positive growth in 2015-2016 of 9.74% to 18.03% but significantly fell into -20.5% in 2017. Operating income also showed a significant growth rate of 18.32% in 2015 to 30.06% in 2016 but fell into -22.56% in 2017. While capital had slowing growth of 16.62% in 2015 to 16.79% in 2016 and decreased into 10.73% in 2017.

Table 3 as below summarized descriptive statistics of the variables included in regressions model as presented. It represents all variables in the research model based on mean, standard deviation, minimum, and maximum value for period 2014-2017. The mean of Maqasid Index (MI) was 0.10348 and had a standard deviation of 0.06548. The highest performance was 0.27610 and the lowest performance was 0.01029. The mean of Profit Sharing Ratio (PSR) was 0.38265 and had a standard deviation of 0.27450. The highest PSR was 0.89085 and the lowest PSR was 0.00000. The mean of Cost Income Ratio (CIR) was 1.03345 and had a standard deviation of 0.30372. The highest CIR was 1.13083 and the lowest CIR was 0.04566. The mean of Capital to Risk Assets Ratio (CRAR) was 0.30373 and had a standard deviation of 0.24506. The highest CRAR was 0.27610 and the lowest CRAR was 0.01029.

Table 3: Descriptive Statistics

| Variables | Mean | Standard Deviation | Minimum | Maximum |
|---|---|---|---|---|
| MI | 0.10348 | 0.06548 | 0.01029 | 0.27610 |
| PSR | 0.38265 | 0.27450 | 0.00000 | 0.89085 |
| CIR | 1.03345 | 0.30372 | 0.04566 | 1.13083 |
| CRAR | 0.30373 | 0.24506 | 0.01029 | 0.27610 |

In table 4, correlation between MI and PSR were 0.846, 0.091 with CIR, and -0.493 with CRAR. MI had positive correlations with PSR and CIR, but had negative correlations with CRAR. The correlation between PSR and CIR were 0.239 and -0.344 with CRAR. PSR had positive correlations with CIR but negative with CRAR. While the correlation between CIR and CRAR were -0.024. In this case, CRAR had negative correlation with all variables.

Table 4: Correlations

| Variables | MI | PSR | CIR | CRAR |
|---|---|---|---|---|
| MI | 1 | | | |
| PSR | 0.846 | 1 | | |
| CIR | 0.091 | 0.239 | 1 | |
| CRAR | -0.493 | -0.344 | -0.024 | 1 |

The strength correlation was measured based on Pearson's Correlation Scale where a value in the interval 0.00-0.30 is an indication of no correlation, 0.31-0.50 is a weak correlation. If the value is 0.51-0.70 is a fair correlation, and in the interval of 0.71-1.00 indicates a strong correlation. A correlation value of 1 indicates a perfect correlation between the variables.

Based on the data in table 4, the higher correlation is 0.846 and it indicated that there had no correlation among dependent variables because all values are less than 0.95 (Ghozali, 2006).

Based on the classical assumption tests, Fixed Effect Model is applicable in this research. Table 5 exposes the regression result according to the research model.

Table 5: Regression

| Variables | Coefficient | t | Prob. |
|---|---|---|---|
| Constant | 0.072 | 3.503 | 0.001 |
| PSR | 0.190 | 9.085 | 0.000 |
| CIR | -0.022 | -1.264 | 0.214 |
| CRAR | -0.059 | -2.606 | 0.013 |
| F | 40.616 | | 0.000 |
| Adjusted R squared | 0.755 | | |

*Significant at 5%

The results demonstrate that the value of adjusted R square is 0.755 and it indicates that the variability of MI is 75.5% explained by PSR, CIR, and CRAR. Therefore, the variability of other factors which were not studied in the current research is 24.5%.

The F-test is used to test the significance of the relationship between dependent variable with independent variables entirely, The F value is 40.616 and the probability is 0.000. The probability is greater than 0.05 so that indicates that all independent variables simultaneously influence dependent variable. It is clear from the results that the relationship between the variables is statically significant.

However, t-test is used to examine the influence independent variables on dependent variable partially. In the test, PSR positively influences MI with t-value of 9.085 in significant level of 0.000 ($p<0.05$). It means that if PSR increases in 1%, MI will increase of 9.085. The t-value of CIR is -1.264 with probability in the level of 0.214 ($p>0.05$) so that this variable does not influence MI. Meanwhile t-value of CRAR is -2.606 in the significant level of 0.013 ($p<0.05$) and indicates that this variable significantly affects MI.

**Conclusion**

In the function of mediating institution, Islamic bank help monetary system that especially prioritized the investment in the welfare of society, environment, and prohibits funding that are likely to results in destruction of natural resources and environment or to cause harm to human being (Saidi, 2009). This objectives accommodated *maqasid shariah* that balancing activities for human interest, skill development, and attention for environment.

This study results some findings that there are significant influence of PSR and CRAR on MI. PSR positively influences MI and indicates that the higher PLS financing increases *maqasid shariah* based performance of Islamic banks in Indonesia. CRAR negatively influences MI so that this finding indicate the higher risk taking behavior decreases maqasid shariah based performance. While CIR does not influence MI and indicates that cost efficiency does not contribute to *maqasid shariah* based performance.

The implication of this research findings, *first*, the robust financial system must be flexible, resilience, and stable. They should be able to accommodate any change, overcome financial problems, and maintain their internal stability. Principally, Islamic bank operates based on interest free-based system to achieve business mission. In the practices, Islamic bank is also balancing business goals, social missions, and spiritual goals through products and regulations based on Islamic law and government policy. *Second*, Islamic banks as a part of Islamic financial system operate based on interest free and profit sharing. For nonprofit loss sharing financing, such as *murabahah* and *ijarah*, it has become an obstacle to *maqasid shariah* achievement because profit maximization is not the ultimate goal of Islamic banks development.

This paper also concludes some important points. First, Islamic banks in Indonesia necessary to extend profit loss sharing financing to strengthen the existence of maqasid shariah. Second, Islamic banks in Indonesia need to consider for decreasing the *murabahah* domination to balance others contract and to follow the Islamic banking principles in their contribution into real sector. And third, Islamic banks have to allocate for working capital and investment to maintain banking stabilization and considered crisis as an external factor that can disturbance their performance.

Banks as an economic agent have a role in maintaining national reserves and preventing crises to stabilize economy. Success parameters should be measured from strong based for sustainable development, industrial structure, and product-service standards. The stability of financial sector is the foundation of steadiness of the entire financial system in the money creation process, payment system, investment, and economic growth (Hussein, 2010). Islamic Banks as a part of monetary system must support real sectors to grow and survive. Furthermore, bank also assure to guide or direct their liquidity and risk to avoid crisis.

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