2022_Muqtasid_Kautsar Riza Salman_Turnitin_New

by Kautsar Riza Salman

Submission date: 03-Jan-2024 08:50AM (UTC+0700)
Submission ID: 2266282427
File name: 2022_Muqtasid_Kautsar_Riza_Salman_Artikel.pdf (1.61M)
Word count: 6526
Character count: 37056

Muqtasid 13(2),2022: 95-111
http://muqtasid.iainsalatiga.ac.id
DOI:http://dx.doi.org/10.18326/muqtasid.V13i2. 95-111

The Determinants of Profit-Loss Sharing Financing of Islamic Banks in Indonesia

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Submitted: 1 May 2022; Accepted: 13 February 2023; Published: 16 February 2023

Abstract

Profit-loss sharing financing is one of the leading business activities carried out by Islamic banks, including buying, selling, and leasing. Thus, it is important to identify the determinants of profit-loss sharing financing of Islamic banks. This study examines the effect of capital adequacy ratios, non-performing financing, third party funds, and profit-sharing rate on *mudharabah* deposits of Islamic banks in Indonesia. Eleven Islamic banks in Indonesia from 2015 to 2019 periode were selected as sample of the study using purposive sampling. Data analysis using Partial Least Square with SmartPLS software version 3.3.7. The study results indicate that third-party funds have a significant positive effect on profit-loss sharing financing. The increasing number of third-party funds that Islamic banks have collected from customers impacts increasing distribution in the form of profit-loss sharing financing. The study results also indicate that the capital adequacy ratio, non-performing financing, and profit-sharing rate on *mudharabah* deposits do not affect profit-loss sharing financing. The implications for Islamic banks are to maintain the amount of third-party funds collection and compliance with sharia principles.

Keywords: capital adequacy ratio, non-performing financing, third-parties, deposit profit-sharing rate, profit-loss sharing financing

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ISSN 2087-7013
ISSN 2527-8304

INTRODUCTION

Islamic banks are identical to profit-loss sharing financing, where profits are shared between Islamic banks and managing customers under the agreed ratio. Profit-loss sharing financing carried out by Islamic banks can use *mudharabah* and *musharakah* contracts. A *mudharabah* contract is a business cooperation agreement between an Islamic bank as the owner of the funds (*shahibul maal*) and the customer as the fund manager (*mudharib*) to carry out business activities if there is profit sharing based on a profit sharing ratio according to the agreement. In contrast, if there is a loss, it will be borne by the fund owner unless it is caused by misconduct, negligence, and violation by fund managers (Salman, 2020). As for the critical concept of a *musharakah* contract, capital is shared by all partners (Islamic banks and customers). Profits are divided accordingly agreed ratio, while losses are shared based on the contribution of funds(Salman, 2021a).

Based on data released by the Financial Services Authority in 2021, the average increase in total financing per year is 8.19% during the 2018-2021 period. Total financing in December 2018 was 202,766 billion and increased to 256,405 billion in December 2021. However, a more significant increase occurred in *mudharabah* profit-sharing based financing with an average increase of 10.62% per year during the 2018-2021 period. The amount of financing based on *mudharabah* profit-sharing in December 2018 was 74,122 billion and increased to 99,615 in December 2021 (Sharia Banking Statistics, 2021).

Profit-loss sharing financing is financing provided by Islamic banks directly related to the real sector, such as financing part or all of the working capital from customers. Therefore, this study investigates the determinants affecting Islamic banks' profit-loss sharing financing include the capital adequacy ratio, non-performing financing, third party funds, and deposit profit-loss sharing rate. Some determinants directly relate to profit-loss sharing financing, namely the profit sharing level and the non-performing financing ratio. Third-party funds collected by Islamic banks are different from conventional banks. Third-party funds in the form of *wadiah* contracts are presented in the statements of financial position as liabilities. In contrast, third-party funds in the form of *mudharabah* and *musharakah* contracts are presented in the statements of financial position as temporary *shirkah* funds(Salman, 2021a).

Most of the previous research examined the determinants of the profit-sharing rate on deposits (Al-Arif, 2011; Aulia & Saputri, 2021; Harfiah et al., 2016; Irwansyah & Hidayat, 2021; Pujiastutik & Sumanto, 2021; Sudarsono & Saputri, 2018) and the effect of the profit-sharing rate on *mudharabah* deposits (Fitrianingsih & Rani, 2020; Romi & Nur, 2019; Ruslizar & Rahmawaty, 2016).

Previous studies have shown contradictory and inconsistent results. There are several studies (Aprizal, 2021; Hilman, 2016; Ramdhani, 2017; Renfiana, 2022) which found a positive effect on the profit sharing rate on *mudharabah* deposits, while other studies

(Hanifah & Anwar, 2020; Menne et al., 2018; Suryadi et al., 2022) found no effect on the level of profit-sharing income on *mudharabah* deposits. Conversely, there are findings that the level of profit sharing has a negative and significant effect on *mudharabah* deposits (Relasari & Soediro, 2017). These studies examine the effect of profit-sharing rates on *mudharabah* deposits, in contrast to the current study, which examines the effect of profit-sharing rates on profit-loss sharing financing. The current study is also different from Iskandar and Adirestuty (2018), showing that profit-sharing rates positively and significantly affect *mudharabah* financing income.

The capital adequacy ratio is the minimum amount of capital that Islamic banks must own, which helps accommodate the risk of loss faced by Islamic banks. The higher the capital adequacy ratio indicates, the healthier an Islamic bank is. Capital adequacy ratio data for the period 2018-2021 shows a consistent increase in growth. The growth of the capital adequacy ratio by 0.98% in 2018-2019, 5.1% in 2019-2020 and 18.81% in 2020-2021 (Sharia Banking Statistics, 2021). However, this was not accompanied by empirical research results contradicting the data. Most research was empirically unable to affect the capital adequacy ratio on profit-loss sharing financing (Kalkarina et al., 2016; Liliani & Khairunnisa, 2015; Winarsih & Asokawati, 2019).

Non-performing financing arises when the customer does not comply with the instalment payment schedule and does not meet the requirements stated in the contract. Data on non-performing financing at Islamic banks decreased from 3.26% in 2018 to 3.23% in 2019 (Sharia Banking Statistics, 2021). Nevertheless, on the other hand, the results of previous empirical research did not find evidence of the effect of non-performing financing on the amount of profit-loss sharing financing (Permataningayu & Mahdaria, 2019; Sakhowi, 2016; Salman, 2021; Winarsih & Asokawati, 2019; Wirman, 2018).

In Islamic banking, third party funds are collected through demand deposits, savings deposits, and time deposits by binding to *wadiah* and *mudharabah* contracts. *Wadiah* contracts are applied to savings deposits and current accounts (Fatwa DSN MUI No. 01/DSN-MUI, 2000; Fatwa DSN MUI No. 02/DSN-MUI, 2000). The *mudharabah* contract can be used in savings, demand, and *mudharabah* deposits (Fatwa DSN MUI No. 01/DSN-MUI, 2000; Fatwa DSN MUI No. 02/DSN-MUI, 2000; Fatwa DSN MUI No. 03/DSN-MUI, 2000).

Although third-party funds show a decrease in growth over the 2018-2020 period, empirical studies show a significant effect of third-party funds on profit-loss sharing financing. In the 2018-2019 period, the growth of third party funds of 9.5% decreased significantly to 4.7% in 2019-2020. However, previous empirical research has empirically proven that third party funds affect profit-loss sharing financing (Hafizh et al., 2020; Nurdiansyah et al., 2020; Primadhita et al., 2021; Riyadi et al., 2021; Rukmana, 2016; Sakhowi, 2016; Winarsih & Asokawati, 2019). The greater the number of third party funds that Islamic banks have

Collected, the greater the amount of profit-loss sharing financing that Islamic banks channel to *mudharib*. *Mudharib* receives financing from Islamic banks through a *mudharabah* contract. *Mudharabah* is a business agreement between *shahibul maal* and *mudharib* to carry out business activities, in which profits are shared based on *nisbah* according to the agreement of both parties. In contrast, if there is a loss, it will be borne by the owner of the funds unless it is caused by misconduct, negligence, and violation by fund managers(Salman, 2021a).

In the context of *mudharabah* deposit, Islamic banks have referred to the Fatwa of the MUI DSN in calculating the profit-sharing that is the rights of the fund owners. The profit-sharing distribution system in Islamic banks uses a cash basis based on Fatwa DSN MUI 14/2000, while the distribution principle uses the revenue sharing principle based on Fatwa DSN MUI 15/2000. The greater the level of profit-sharing the customer receives affects the customer to invest their funds in savings, demand deposits, or *mudharabah* deposits based on profit-sharing in Islamic banks. It impacts increasing the disbursement of funds through profit-loss sharing financing to customers. The current research is expected to yield both empirical and practical contributions. Empirical contribution to answer gap research regarding the determinants of profit-loss sharing financing that has been described previously. Practical contributions for Islamic bank financial institutions regarding factors that must be considered to increase profit-loss sharing financing.

METHOD

The method used in this research is quantitative research. Quantitative research uses hypothesis testing to test the effect of the independent variable on the dependent variable (Al-Sabbah, 2015). This research is quantitative because it examines the effect of profit-sharing rate, non-performing financing, and capital adequacy ratio variables on profit-sharing-based financing. The grounded theory used in this study to explain the relationship between variables is agency theory. Agency theory proposes that control mechanisms reduce agency costs (Jensen & Meckling, 1976) and consequently improve financial performance (Ben Abdallah & Bahloul, 2021; Fama & Jensen, 1983). The conceptual framework of this research is shown in Figure 1.

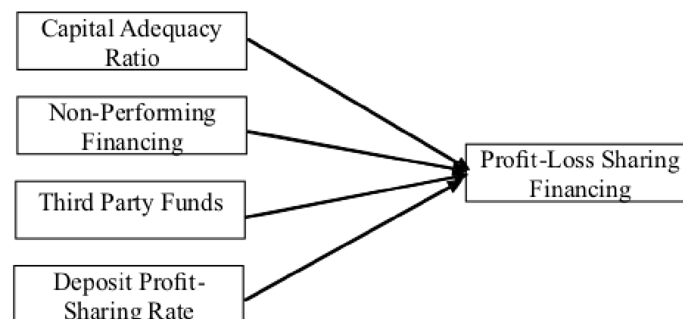

Figure 1. Theoretical Framework

Variables

The following linear model specifications are formulated in this paper to assess the impact of capital adequacy ratio, non-performing financing, third-party funds, and deposit profit-sharing rate on profit-loss sharing financing:

$$PLS - F_t = \alpha + \beta_t CAR_t + \beta_t NPF_t + \beta_t TPF_t + \beta_t DPSR_t + \varepsilon_t$$

Where a measure of profit-loss sharing financing, PLS-F, is the dependent variable and capital adequacy ratio, CAR, is the first independent variable, the non-performing financing ratio, NPF, is the second independent variable, third party funds, TPF, is the third independent variable, deposit profit sharing rate, DPSR, is the fourth independent variable. The variables are measured on a ratio scale.

Profit-loss sharing financing (PLS-F) is financing Islamic banks provide to customers to manage a business. Profit-loss sharing financing consists of *mudharabah* and *musharakah* financing (Abbas & Arizah, 2019). The characteristic of *mudharabah* financing is that profits are shared according to *nisbah*, and the *shahibul maal* bear's losses. The characteristics of *musharakah* financing are that profits are shared according to the agreed ratio, and losses are shared proportionally according to both parties' capital size (Nugraheni & Alimin, 2022). Profit-loss sharing financing is an equity contract with no guarantee of return (Baldwin & Alhalboni, 2020; Farook et al., 2012).

The capital adequacy ratio (CAR) measures the ratio of capital to risk-weighted assets. CAR plays a vital role in protecting the interests of depositors, increasing the competitiveness of financial institutions, and maintaining financial market stability (Francis & Osborne, 2012; Gander, 2013; Wang et al., 2022) so that regulators and policymakers focus on maintaining the level of capital adequacy ratio (CAR) to minimize solvency and liquidation risks (Mohanty & Mahakud, 2019). A higher CAR value indicates lower bank financial health and risk (Majeed & Zainab, 2021).

The non-performing financing (NPF) ratio reflects a measure of the stability of an Islamic bank. Banks must keep non-performing loans or financing to a minimum (Kuzucu & Kuzucu, 2019) to create a stable banking system (Giammanco et al., 2022). The NPL ratio at conventional banks measures credit risk, including non-performing financing and provisions to evaluate the banking sector's stability, fragility and long-term financial sustainability (Ashikuzzaman, 2022). The large NPF ratio reflects the high risk of Islamic banks in facing the problem of congestion on disbursed financing (Iriani & Yuliadi, 2015; Sechafia & Abduh, 2014).

Third-party funds (TPF) are the number of deposit funds obtained by Islamic banks from the public. Current accounts and savings use *wadiah* and *mudharabah* contracts, while

Deposits use *mudharabah* contracts. Third-party funds collected by Islamic banks are used to measure the efficiency of Islamic banks (Puteh et al., 2018) and affect the amount of Islamic business financing (Damanhur et al., 2018; Widiastuty, 2017). Third-party funds with *wadiah* contracts are presented on the liability side. In contrast, third-party funds with *mudharabah* contracts are presented on the temporary *shirkah* funds side in the financial statements of Islamic banks (Putri & Mardian, 2020). Islamic banks manage third-party funds in a trustful manner under the principles of Islamic law (Yuri et al., 2021).

Deposit Profit Sharing Rate (DPSR) is a measure of profit sharing received by Islamic banks in managing funds received by depositors. This variable is measured by the ratio of the level of sharing received by Islamic banks divided by the amount of financing. In investment savings in *mudharabah* contracts, depositors or customers called *rabbul maal* look for investment opportunities and will invest their capital through a bank called mudharib that manages the funds (Hamzah et al., 2014; Hati et al., 2020). In managing this type of deposit, known as a risk-sharing deposit (Ibrahim et al., 2022), there is a profit-sharing structure at the asset level of Islamic banks (bank-entrepreneur relationship) and the profit sharing structure at the level of Islamic bank obligations (bank-depositor relationship) (Ben Amar & El Alaoui, 2023).

Sampling Method

The population of this study is all Islamic banks in Indonesia with the status of Islamic commercial banks. The sampling method used is purposive sampling, where the criteria proposed are the availability of financial statements for the 2015-2019 period research period before the covid-19 pandemic in early 2020 to produce unbiased data. The purposive sampling method is used to achieve a manageable amount of data (Ames et al., 2019). The number of samples of Islamic banks that meet the criteria is eleven Islamic commercial banks, so the number of observations (n) is 55 (5x11). The eleven Islamic commercial banks are Bank Muamalat Indonesia (BMI), Bank BNI Syariah (BNIS), Bank Syariah Mandiri (BSM), Bank BRI Syariah (BRIS), Bank Victoria Syariah, Bank Jabar Banten Syariah, Bank Panin Dubai Syariah, Bank Syariah Bukopin, Bank BCA Syariah, Bank Mega Syariah, and Bank Maybank Syariah.

Data Analysis Technique

Partial least squares (PLS) allow the measurement and structural models to be examined simultaneously. In addition, PLS requires fewer assumptions than factor-based SEM techniques (Petter & Hadavi, 2021). The current study uses PLS because the number of samples used is relatively small and the model used is a structural model that is tested simultaneously.

RESULT AND DISCUSSION

The descriptive statistics of the research variables are shown in Table 1.

Table 1. Statistics Descriptives

No	Variables	Mean	Min	Max	Standard Deviation
1	Capital Adequacy Ratio	0.2795	0.1151	2.4184	0.3670
2	Non-Perfoming Financing	0.0313	0	0.3771	0.0545
3	Third-Party Funds	1.8738	0.0000001	9.9804	2,4263
4	Deposit Profit-Sharing Rate	0.0979	0	0.3932	0.0492
5	Profit-Loss Sharing Financing	0.6024	0	2.7663	0.7147

The quality of Islamic bank financing in the study period (2015-2019) was at most 5% of total financing. The capital adequacy ratio in the study period (2015-2019) exceeded 8%, so Islamic banks could absorb the risk of losses they would face. The highest CAR of 2.4184 was obtained by Bank Maybank Syariah in 2019, while Bank Panin Dubai Syariah obtained the lowest CAR of 0.1151 in 2017. Bank BCA Syariah showed an NPF ratio of 0.000 in the 2016-2019 period, while Bank Maybank Syariah obtained the highest NPF ratio of 0.3771 in 2016. The highest third-party funds were 9.9804, obtained by Bank Syariah Mandiri in 2019, and the lowest was 0.0000001 at Bank Maybank Syariah in 2019. Bank Maybank Syariah obtained the highest profit-sharing rate of 0.3932 in 2017, and Bank Maybank Syariah obtained the lowest profit-sharing ratio in 2019 (Table 1).

R Square

Based on the results of data analysis, the R Square value is 77.5%, and the R Square Adjusted value is 75.7% (Table 2). These results indicate that the research model is robust because it can influence profit-sharing-based financing by 75.7%, and variables outside the research model influence the remaining 24.3%.

Table 2. R Square

	R Square	R Square Adjusted
Profit-Loss Sharing Financing	0,775	0,757

Path Coefficients

Based on the path coefficient analysis, it is obtained that only third party funds have a significant influence individually on profit-sharing-based financing, where the t-statistical value is 12.713, and the p-value is 0.000. On the other hand, the analysis results show that the capital adequacy ratio, non-performing financing and deposit profit-sharing rate do not

Significantly affect profit-sharing-based financing because they have a p-value above 0.05 (Table 3).

Table 3. Path Coefficients

No.	Research Hypothesis	Original Sample	T Statistics	P Values
1.	Capital Adequacy Ratio → Profit-Loss Sharing Financing	-0.035	0.709	0.478
2.	Non-Performing Financing → Profit-Loss Sharing Financing	0.010	0.218	0.827
3.	Third-Party Funds → Profit-Loss Sharing Financing	0.872	12.713	0.000
4.	Deposit Profit-Sharing Rate → Profit-Loss Sharing Financing	-0.011	0.232	0.817

Based on the path coefficient (Table 3), the regression equation of this model is:

$$PLS - F = -0.035CAR + 0.010NPF + 0.872TPF - 0.011DPSR$$

The Effect of Capital Adequacy Ratio on Profit Sharing Financing

Based on the data analysis, the results show that the capital adequacy ratio does not affect profit-sharing-based financing. The capital adequacy ratio indicates whether the existing capital is adequate for Islamic banks to cover the risk of losses that will reduce capital. According to Financial Services Authority Regulation 21 (2014), the minimum CAR is 8%. Looking at the average capital adequacy of Islamic banks during the study period of 27.95% and the lowest CAR of 11.51% is quite good but empirically proven does not affect profit-sharing-based financing.

Based on research findings indicate that the amount of financing disbursed is not affected by the capital adequacy ratio (CAR). These findings are supported by the instability of the capital adequacy ratio during the research period (2015-2019). There was a decrease in the CAR ratio of Islamic banks in Indonesia in 2016 from 0.1912 to 0.1878 in 2017. Likewise, there was a decrease in CAR of 0.20521 in 2018 to 0.1969 in 2019. The results of this study support Winarsih and Asokawati (2019), Kalkarina et al. (2016) also Liliani and Khairunnisa (2015), who did not find the effect of the capital adequacy ratio on profit-sharing-based financing.

The Effect of Non-Performing Financing on Profit Sharing Financing

Based on data analysis, empirical findings are obtained that non-performing financing does not affect profit-sharing based financing. The average non-performing financing ratio

during the study period shows that 3.13% is still below the 5% required by the Financial Services Authority regulations(Bank Indonesia Regulation Number 24/3/Pbi/2022). However, the highest ratio of 37.71% during the study period indicates an unhealthy Islamic bank. It impacts the decline in the performance of Islamic banks and ultimately reduces profit-sharing-based financing distributed to the public.

The results of the study show that the size of the value of profit-loss sharing financing is not affected by the non-performing financing ratio. Even though there was a decrease in the non-performing financing ratio during the study period (2015-2019) from 0.03274 in 2015 to 0.01762 in 2019, this condition did not affect the amount of financing provided by Islamic banks. It could be due to an increase in the non-performing financing ratio 2017 of 0.0204 to almost double to 0.0336 in 2017. The results of this study are in line with Salman (2021), Winarsih and Asokawati (2019), Wirman (2018) and Sakhowi (2016) did not find the effect of non-performing financing on profit-sharing-based financing.

The Effect of Third Parties on Profit Sharing Financing

Based on data analysis, the results obtained that third-party funds significantly affect bank distribution through profit-sharing-based financing. This result is consistent with the concept that the greater the third-party funds successfully collected by Islamic banks, the greater the ability of Islamic banks to channel them into profit-sharing-based financing. It can increase the income of Islamic banks (Sukmawati & Purbawangsa, 2016).

The outcomes of the study are in line with prior research conducted by Primadhita et al. (2021), Nurdiansyah et al. (2020), Hafizh et al. (2020), Winarsih and Asokawati (2019), Sakhowi (2016), and Rukmana (2016). All previous studies used multiple linear regression, while the current study used partial least squares and the latest data for five years from 2015 to 2019. Although there are differences in data analysis techniques between the current and previous studies, the findings are the same; namely, third-party funds significantly influence profit-sharing-based financing. This finding is supported by the increase in the average amount of party funds collected by Islamic banks consistently in the research period (2015-2019) from 15.537 trillion in 2015 to 22.936 trillion in 2019. Likewise, profit-loss sharing financing increased consistently during the period research (2015-2019) from 4.925 trillion in 2015 to 7.603 trillion in 2019. Thus, the size of profit-loss sharing financing is influenced by the number of third-party funds collected from the public.

Similarly, the findings of this study are in line with Riyadi et al. (2021). Riyadi et al. (2021) used the co-integration and error correction model (ECM) from data from the first

Quarter of 2015 to the third quarter of 2020. It was found that there was an influence of third party funds on profit-sharing-based financing. However, the data used occurred during the covid-19 pandemic.

The Effect of Deposit Profit-Sharing Rate on Profit Sharing Financing

Based on the data analysis outcomes, the profit-sharing rate of *mudharabah* deposits did not affect profit-sharing-based financing. During the study period, the average profit-sharing rate for *mudharabah* deposits was 9.79% per year, with a minimum value of 0%, indicating the amount of profit-sharing received compared to the number of deposits based on the *mudharabah* principle. This profit-sharing rate has no effect on distribution in the form of profit-loss sharing financing to customers. The high and low profit-loss sharing financing is not caused by the level of *mudharabah* deposits but is caused by the number of third party funds that Islamic banks have collected.

The study results show that profit-loss sharing financing is not affected by the profit-sharing rate of deposits. This finding is supported by a decrease in the profit-sharing ratio received by Islamic banks as mudharib during the research period (2015-2019). The profit-sharing rate ratio of 0.1038 in 2015 decreased to 0.0855 in 2019, although there was an increase from 0.0895 in 2016 to 0.09958 in 2017. This finding proves that Islamic banks such as mudharib must effectively manage their funds received from depositors or customers. It is indicated by a decrease in the profit-sharing ratio received by Islamic banks during the research period (2015-2019). The study results differ from Iskandar and Adirestuty (2018), who found a positive effect on the profit-sharing rate of *mudharabah* financing income. The current study results show that the level of profit sharing has no impact on profit-loss sharing financing. Profit-loss sharing financing in this study is broader by including *mudharabah* and *musharakah* contracts.

CONCLUSION

This study aims to acquire empirical evidence regarding the effect of capital adequacy ratios, non-performing financing, third-party funds, and the level of profit-sharing on deposits on profit-loss sharing financing of Islamic banks in Indonesia over the period from 2015 to 2019. This research has succeeded in empirically proving the effect of third party funds on profit sharing financing. The increase in the number of third party funds that have been collected by Islamic banks using the *mudharabah* and *wadiah* principles has been empirically proven to increase the amount of profit-loss sharing financing. This finding aligns with

previous theories, concepts, and empirical research that Islamic banks as intermediary institutions in channelling funds depend on the amount of fund collection from third parties.

On the other hand, the study results are not able to empirically prove the effect of the capital adequacy ratio, non-performing financing, and the level of profit-sharing on deposits on profit sharing financing. During the study period, Islamic banks have a good capital adequacy ratio, but the capital adequacy ratio has no significant effect on profit sharing financing. Likewise, non-performing financing has been well managed by Islamic banks. However, the low level of non-performing financing in Islamic banks does not correlate with the amount of profit-loss sharing financing disbursed. The results of this study also obtain the first empirical evidence that the level of profit-sharing does not affect profit-loss sharing financing.

This research has practical implications, especially for Islamic banks, regarding the importance of raising third party funds. Islamic banks must maintain compliance with sharia principles related to collecting third party funds. In addition, media promotions are increasingly being intensified to raise awareness of the Indonesian people, who are predominantly Muslim, to entrust their funds with *wadia*h contracts or invest their funds in *mudharabah* contracts in Islamic banks. The growing public awareness of saving in Islamic banks is expected to significantly increase the number of party funds and ultimately increase the amount of profit-loss sharing financing.

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