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The Impact of Mudharabah and Musharakah based Financing to Credit Risk

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Abstract

Introduction to The Problem: Indonesian Islamic banking possesses riskier credit risk than conventional banking system. The Islamic financing system in Indonesia is done through mudharabah and musharakah scheme with the profit and loss sharing system.

Purpose/Objective Study: This research aims to analyze the impact of mudharabah and musharakah to the credit risk of Islamic bank in Indonesia.

Design/Methodology/Approach: Variables used in this research are financing data with mudharabah and musharakah contract, credit risk shown by Non-Performing Financing (NPF). The reaserch estimated time series data from January 2016 to June 2019 with Ordinary Least Square (OLS).

Findings: The results show that Mudharabah possesses higher risk than musharakah and both contract affect the non-performing financing significantly. Profit and loss sharing presentation has negative sign to the NPF, this means that the greater return that the consumer receive will make them feel more secure and thus reduce the non-performing financing. Inflation does not affect NPF significantly.

Paper Type: Research Article

Keywords: Mudharabah, Musharakah, Credit Risk

Note: The total of word accounts in abstract should not more than 300 words

Introduction

Indonesia is one of the most populous Muslim countries in the world. Indonesia has dual banking system namely conventional banking system and Islamic banking system. The Islamic banking system grows rapidly. The first Islamic bank was Bank Muamalat which established in 1991. Now, there are 13 Sharia Commercial Banks and 21 conventional banks with Sharia Business Unit. Table below shows the comparation between conventional bank and Islamic bank.

Table 1. Comparation of Islamic Bank and Conventional Bank in Indonesia

	Islamic Bank	**Conventional Bank**
Asset	Rp 395.093 Billion	Rp 7.150.388 Billion
Number of units	2.189	32.602
Third Party Fund	Rp 318.573 Billion	Rp 5.142.891 Billion
Financing / Loan	Rp 110.058 Billion	Rp 4.597.206 Billion

Source: OJK (2019)

The market share of Islamic Bank as of August 2017 is 5.44% still low compared to the conventional bank's market share. The asset growth of Islamic Bank is 24.2% as of August 2017. Indonesia is currently at the 9th rank of world's Islamic finance. With the level of penetration 2.5%, Indonesia is below Malaysia of 15.5% and Saudi Arabia of 33.1% .

Islamic banking financing in Indonesia keeps increasing each year. Financing in Islamic bank is based on mudharabah and musharakah aqd. In mudharabah, bank acts as the fund/capital provider and another party acts as the business manager. The proportionate share in profit is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour. While Musharakah is a joint enterprise or partnership structure in Islamic finance in which partners share in the profits and losses of an enterprise. Since Islamic law (or Sharia) does not permit profiting from interest in lending, musharakah allows for the financier of a project or company to achieve a return in the form of a portion of the actual profits earned according to a predetermined ratio. However, unlike a traditional creditor, the financier also will share in any losses should they occur.

In Islamic Financing, the return must not be in a form of interest rate, rather it is in a form of profit and loss sharing. As of 2017, the financing in Islamic bank is Rp 110 058 billion while credit/loan in conventional bank is Rp 4 597 206 billion. Despite the increasing rate of the market share of Islamic bank, the financing in Islamic bank is still low compared to the credit of conventional bank.

Profit and loss sharing is the suitable mechanism according to Islamic principles. However, some countries still use the fixed return for credit because of some factors, one of which is the higher possessed by profit and loss sharing compared to the conventional fixed return. Also, there might be an adverse selection in using profit and loss sharing. The adverse selection happens when the debtors do not give complete information regarding the cost and revenue they receive. This causes the monitoring should be strictly done and therefore causing higher cost for the bank.

According to research conducted by Abedifar (2013), financing with profit and loss sharing system will increase the risk of Islamic banking because of the occurrence of asymmetric information, adverse selection, moral hazard, and expensive strict monitoring.

Another research conducted to the Malaysian Islamic Banking. The risk problems in the Malaysian Islamic banking system could be due to the usage of PLS modes of finance. Most of the problems result from the information asymmetry, which may lead to moral hazard behavior of the borrowers.1 It should be noted that PLS modes of finance are frequently used by some Malaysian Islamic banks. Islamic banks' involvement in delivering special products, i.e. mudaraba and musharaka, showed that the average supply of loans under this category could incur higher risk for the Islamic banks in Malaysia. This may be due to several reasons. Firstly, alternative modes of financing such as Ijara and Murabaha are seen as less risky and more profitable than mudaraba and musharaka. Secondly, the monitoring cost of the mudaraba and musharaka is very high for the bank and lastly, many may not be openly enough to the opinion of sharing joint management (Lassoued, 2018).

Non-Performing Loan (NPL) of Islamic banking in Indonesia as of December 2018 is 3.28%, while conventional banking is 2.6%. This shows the greater risk possessed by the Islamic banking with its profit and loss sharing mechanism. Financing in Islamic banking is done through mudharabah and musharakah. Those are Islamic financing mechanism used by the Islamic banking.

Ahmed (2010), Chong and Liu (2009), Zeineb and Mensi (2014) conducted reasearches regarding the profit and loss sharing based financing. The profit and loss sharing mechanism will enhance the strictness in monitoring and applying regulations. Banks will tend to watch the business strictly and require accurate reporting to ensure the business runs well and to protect their assets.

Misman (2012) and Abusharbeh (2014) conducted reasearches regarding impact of profit and loss sharing to credit risk. It is said that the profit and loss sharing mechanism will increase the credit risk. Financing with profit and loss sharing causes the incomplete information by the debtor regarding their business financial status. This will obstruct the bank to conduct precise assessment to the business.

Warninda (2019) conducted a research regarding the impact of mudharabah and musharakah to the risk of Islamic banking in 63 Islamic banks in Middle East, South Asia, and South East Asia. The result shows that musharakah has higher risk compared to mudharabah. The result also shows that the credit risk reaches maximum when the proportion of musharakah to mudharabah is 37-39%.

A research was conducted to analyze the relationship between credit risk and the Islamic bank financing scheme. There is no causal relationship between the credit risk and musharakah based financing, which is the mode of financing where the Islamic bank shares the risk with its clients, but there is an influence of credit risk toward mudarabah mode financing, a financing mode where the Islamic bank bears all the risk. These findings can lead us to conclude that the Indonesian Islamic banking sector is based on the "risk sharing" system (Diallo et al., 2015).

This research aims to analyze the impact of mudharabah and musharakah to NPL of Islamic banks in Indonesia. This research also includes other macroeconomics variable.

Methodology

This research aims to analyze the impact of mudharabah and musharakah to the credit risk of Islamic bank in Indonesia. Variables used in this research are financing data with mudharabah and musharakah contract, credit risk shown by Non-Performing Financing (NPF). Other variables are profit and loss sharing, inflation. Data used is from January 2016 until June 2019. According to the research conducted by Warninda et. al. (2019), this research model is as follows:

$$\mathbf{NPFt = \alpha 0 + \alpha 1 \ ln \ (MUDt) + \alpha 2 \ ln \ (MUSt) + \alpha 3 \ ln \ (TBHt) + + \alpha 4 \ Inft + \varepsilon t}$$

The model is analyzed with Ordinary Least Square (OLS). NPF (Non-Performing Financing); MUD (Mudharabah); MUS (Musharakah); TBH (Profit and loss sharing); Inf (Inflation). The hypotheses are:

1. Mudharabah possesses lower risk than musharakah
2. Mudharabah and Musharakah significantly affect the non-performing financing

Results and Discussion

Table below shows the result of the estimation using OLS.

Table 2. Estimation Result

Variable	Coefficient	Prob.
TBH	-0.368653	0.0927
Ln_MUS	-3.694294	0.0000
Ln_MUD	3.911220	0.0002
Inflation	0.114732	0.4658
C	12.65788	0.2018
R-Squared	0.826763	

Profit and Loss Sharing

According to the result, variable profit and loss sharing (TBH) has negative sign and significantly affects the non-performing financing (NPF) as the proxy for credit risk. The higher TBH will attract the costumer because they will see that the investment is more profitable, thus they will obey the regulations involved. So that it will reduce the risk regarding moral hazard and adverse selection.

Musharakah

Musharakah has negative sign and significantly affects the NPF. This shows that the higher the financing with musharakah credit, the lower the NPF. This finding is not in line with the research conducted by Warninda et. al. (2019) which stated that musharakah possesses higher risk than what mudharabah has.

Mudharabah

Mudharabah has positive sign and significantly affects the NPF. This means the higher the financing with mudharabah contract will lead to the higher NPF. This shows that mudharabah of Islamic banks in Indonesia possesses greater risk than musharakah. This might be caused by the risk of adverse selection and moral hazard where they do not give complete information regarding the business' financial status. The case occurs because in mudharabah, the debtors do not contribute fund, the fund is 100% comes from the creditor, bank itself. Risk return in mudharaba financing is more volatile than that in musharaka as it is potentially driven by agency problems (Ernawati, 2016).

Inflation

Inflation as macroeconomic variable used in this research does not significantly affect the NPF. This result is in line with the research conducted by (Khodaei Valahzaghard et al., 2012) that inflation has no significant impact on credit risk.

Conclusion

The findings in this research are not in line with the hypotheses. Mudharabah possesses higher risk than musharakah and both contract affect the non-performing financing significantly. Mudharabah has positive sign which means the higher the financing with mudharabah contract will lead to higher risk or higher NPF. As for musharakah, the higher the musharakah contract financing, the lower the NPF. Profit and loss sharing presentation has negative sign to the NPF, this means that the greater return that the consumer receive will make them feel more secure and thus reduce the non-performing financing. Inflation does not affect NPF significantly.

The results show that Islamic banks in Indonesia should give bigger proportion to financing with musharakah contract as it possesses lower risk than mudharabah. The monitoring and regulation should be made stricter in order to reduce the risk, namely incomplete information, adverse selection and moral hazard. In other words, the banks need strict regulations in order to give better and precise assessment to the business.

It is more secure for Islamic banking to allocate funds in musharaka contract, which is an alternative to murabaha. However, musharaka contract is less attractive due to lower potential returns. Although high returns are more promising in mudaraba, this financing mode has higher risk of returns (Ernawati, 2016).

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