**Jurnal Tabarru' : Islamic Banking and Finance**
Volume 1 Nomor 2, November 2018
p-ISSN 2621-6833
e-ISSN 2621-7465

# THE EFFECT OF NON PERFORMING FINANCING MUDHARABAH AND MUSYARAKAH AND OWNERSHIP OF BANKS ON THE PROFITABILITY OF SHARIA BANKS

**Hamdi Agustin[1], Hariswanto[2] & Nawarti Bustamam[3]**
*Fakultas Ekonomi, Universitas Islam Riau[1,2 & 3]*
*Email: hamdiagustin@eco.uir.ac.id, hariswanto@eco.uir.ac.id, nawartibustamam@eco.uir.ac.id*

**ABSTRAK**

Penelitian ini bertujuan untuk menganalisa pengaruh dari *Non-Performing Financing* (NPF) pembiayaan *Mudharabah* dan pembiayaan *Musyarakah* dan kepemilikan bank terhadap profitabilitas pada bank umum syariah. Penelitian ini menggunakan populasi sebanyak 13 bank syariah, namun karena keterbatasan kelengkapan data, maka sampel yang digunakan hanya 7 bank syariah pada periode 2012-2016. Hasil penelitian menunjukkan bahwa *Non Performing Financing* (NPF) pembiayaan *Mudharabah* dan pembiayaan *Musyarakah* memiliki pengaruh signifikan negatif terhadap profitabilitas (ROA). Hasil penelitian ini menunjukkan bahwa ada kredit macet (NPL) yang dapat mengurangi profitabilitas bank syariah dalam pembiayaan *Mudharabah* dan pembiayaan *Musyarakah* meskipun jumlah pendanaannya sangat kecil dibandingkan dengan pembiayaan *Murabahah*. Sedangkan variabel kepemilikan bank tidak mempengaruhi profitabilitas bank syariah

**Kata Kunci : *Non Performing Financing*, Pembiayaan *Mudharabah*, Pembiayaan *Musharakah*, Profitabilitas.**

***ABSTRACT***

*The purpose This study to analyze the effect of Non Performing Financing of mudharabah financing and musyarakah financing and bank ownership on profitability at Sharia Commercial Bank. The population in this study as many as 13 sharia banks but due to the limitations of the completeness of the data then the sample in this study taken 7 Sharia Banks period 2012-2016. The results showed that Non Performing Financing Mudharabah financing and Non Performing Financing Musyarakah financing have a significant negative effect on Profitability (ROA). The results of this study indicate that there are non-performing loans that can reduce the profitability of sharia banks in mudharabah and musyarakah financing although the amount of funding is very small compared to murabahah financing. While the variable ownership of the bank does not affect the profitability of sharia banks.*

***Keywords : Non Performing Financing, Mudharabah Financing, Musharaka financing, Profitability.***

## INTRODUCTION

Both Islamic banks and conventional banks are financial intermediation that helps to transfer the funds from investors, depositors or savers to borrowers. Regular conventional banks cannot be involved in venture transactions or merchandizing transactions, which is allowed in Islamic banks. But there are merchant banks who are allowed to do merchandizing. The main difference between Islamic banks and conventional banks are the practice of interest rate and speculative transactions, investment in alcohol, in tobacco and in pig made products are prohibited in accordance with Islamic principles. Generally, conventional banking principles are man-made, whereas in Islamic banks principles and rules are based on *Syariah* who set up the principles, simply to say transactions of Islamic banks are based on profit and loss sharing. As we are aware of, that interest rate for conventional banks is main source of earnings. As a proof, interest is forbidden in not only Islam and in Christianity as well. Likewise, as it is being stated in Quran chapter 3, verse 130 " O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful." And another proof in Quran chapter 2, verse 275 is "Allah has permitted trade and has forbidden interest. Unlike Islamic Banks, the conventional banks are not allowed to purchase commodities with the aim of reselling them, in other words it is forbidden for them to buy capital assets or fixed assets such as: building, tracks, cars, machineries with the purpose to resell them with mark up unless they do not use for their own.

The extent of literature on Islamic banking divided into theoretical and empirical dimension. The earliest works dealing with the potential of Islamic banking include Mannan (1968), Ahmad (1987), Saeed (1996) and Iqbal and Mirakhor (1999). These authors discussed a wide range of institutional issues including concepts and principles that are subject to interpretation. Due to the rapid growth in Islamic banking in these recent decades, it calls for opportunities for the academics to conduct study in analyzing its' financial performance using financial ratios. Some previous studies investigated performance of Islamic banks and compare it with conventional banks performance (Samad, 1999; Samad and Hassan, 2000; Iqbal, 2001; Rosly and Bakar, 2003; Samad, 2004; Kader et. al, 2007; Widagdo and Ika; 2007; Beck et al., 2010; Jaffar and Manarvi, 2011; Ansari and Rehman, 2011; Wahidudin at al., 2012; Merchant, 2012; Zeitun, 2012; Babatunde and Olaitan, 2013)

The research result was conducted by Kithinji (2010), Kargi (2011), Kolapo et al. (2012), Muhammad et al (2012), Samuel et al. (2012), Madishetti, and Rwechungura (2013) and Kingu et al (2018) found that the NPL bank have negative influence toward bank performance. The research result was conducted by Reaz (2005), Berger et al. (2005), Omran (2007), Micco et al. (2007), Iannotta et al. (2007), Fu and Heffernan (2008), and Cornett et al. (2010) found that the ownership structure of private bank have positive influence or significance toward bank performance, from that research can be shown that the private bank is better than government bank. In Indonesia, the research was done by Hadad et al. (2005) found that bank ownership has no effect on performance of private bank, government bank and foreign bank. Thus, the research on the performance of private banks and

government banks in Indonesia is very reasonable to be examined.

Generally, the basic motive for this study is that, different studies were done in Western Europe and East African countries (Saba *et al.* (2012), Louzis *et al.* (2010), Badar and Yasmin (2013) and Moti *et al.* (2012). However, the results of those studies were inconsistent. This inconsistency of results might be attributable to the method of data analysis used by different researchers and difference in the economic condition of the countries in which banking sectors are operating. Though, there are a number of studies that are conducted at a global level to examine the determinants of bank performance, most of the studies were made with reference to developed countries like India, China, Japan, Turkey, United of Kindom, Spain, Greece, German, Malaysia and USA.

In previous literature, a lot of work is done on determining the factors which influence the bank performance in Indonesia. But a little work is done on of sharia banks. Studies in Indonesia, so far have looked into the performance of conventional banks but did not study the effect of nonperforming loan and ownership structure on the performance of sharia banks. So, the main purpose of this study is to fill this gap by performance of sharia banks.

## LITERATURE REVIEW

### Financial Intermediary Theory

The main function of the bank is as a financial intermediary where the bank will sell a financial claiming product on the bank such as savings account and current account. At the same time, banks will also purchase financial products such as mortgages, business loans and personal loans. With this activity the financial transfers occur from units with surplus funds to units with insufficient funds through financial intermediaries. Financial intermediaries have advantages over individual or non-financial companies due to three factors. First, financial institutions or intermediaries can reduce transaction costs such as search costs, information costs and contract costs. The cost of information exists because there is one party who does not know exactly about the information related to the other party.

There are two situations of asymmetric information in financial markets ie adverse selection, which occurs before a transaction occurs, and the moral hazard, which arises after a transaction (Allen & Santomero, 1998). Adverse selection occurs when the surplus unit has no accurate information regarding unit deficit. Therefore, the lack of information about the deficit unit will expose the surplus unit to greater risk if the surplus unit lend to a deficit unit. Financial institutions through experience can reduce the adverse selection problem.

Moral hazard refers to the misuse of the loan obtained by the deficit unit where the deficit unit will use the loan for a more risky and different purpose than the stated purpose of the loan application. Financial institutions can mitigate moral hazard problems through loan contracts and oversight over the operations of deficit units.

The advantage of the second financial institution is that financial institutions can enjoy economies of scale as financial institutions have the ability to handle large and large-scale transactions. Therefore, financial institutions can reduce the fixed cost for each unit of output. Thirdly, since financial institutions have the advantage of evaluating a decent loan deal, it ensures that the loan issued will have a lower risk. Furthermore, financial institutions will manage a large amount

of loans. Thus, financial institutions can diversify their portfolio and thus reduce the risk of such financial institutions. This is different from those of non-financial intermediaries or companies who do not have the skills in assessing a loan and do not have a large capital to diversify their portfolio.

**Agency Theory**

In the area of study of the influence of ownership on bank performance, the most frequently used theory is agency theory. Agency theory describes the relationship between the owner as a principal and manager as an agent. The relationship is very important because it affects the performance of a bank. Thus the competitiveness of a bank depends largely on the ability of managers to manage their respective banks. In addition to the magnitude of the role of managers in managing the bank in order to perform well, the role of the bankers is also vital for monitoring and ensuring that managers are working hard to advance the bank under its management.

Therefore, in the relationship between the bank owner and the manager usually there will be a performance contract where the bank owners are aligning the interests of the manager with the interests of the bank's owner. Performance contracts are formed so that rewards received by managers are closely linked to bank performance. The contractual relationship between the owner and the manager is in line with agency theory (Jensen & Meckling, 1976). Jensen and Meckling (1976) reveal that the difference in importance between owners and managers that creates an agency conflict occurs because the manager does not hold company shares or has insufficient ownership.

The concept of agency as disclosed by Jensen and Meckling (1976) can be seen in the results of the study of Berger and Bonnaccorsi (2006), Basu et al. (2007) and Sulivan and Spong (2007) which indicate that bank owners are handing over to the manager as an agent to manage the bank. This is because the owner has difficulty managing the company directly because of the following factors. First, the size of a growing bank will be difficult to manage. Second, the need for specialized expertise to manage large banks and generally the owners have no such expertise. Third, bank ownership is determined by the number of shareholders. If the number of shareholders is too high and each person holds a small number of shares then this situation does not allow all owners to manage the activities of banks effectively.

The manager can be seen as an agent by the bank owner who appoints them and is authorized and responsible for making the best decisions in the interest of shareholders. One way to measure success and efficiency of managers is to look at the profitability of the bank. Performance can be measured through bank's ability to secure a stable profit while at the same time maintaining shareholder wealth increase in the company.

Berger and Bonnaccorsi (2006) point out that managers may ignore the interests of shareholders, instead paying attention to their interests such as job continuity, luxury lifestyle, professional membership, personal vehicle facilities, all of which are borne by the company. Shleifer and Vishny (1997) stipulate to address agency issues, shareholders have incentives to monitor managers so as to minimize the problem of principal-agents. However, the level of incentives depends on shareholder ownership. If the owner holds a small number of shares, the owner will not have the incentive to monitor the manager's behavior. This is

because the profit earned by the owner is less than the cost of supervision. Therefore, it is expected that private banks, most of which are owned by a family, will have a better performance compared to government-owned banks.

For a bank that is largely owned by the family, conflicts between bank owners and managers are rare. Arifin (2003) notes that when a majority of the shares are owned by the family, it reduces the agency's problems compared to companies owned by many shareholders. In Indonesia, 90 percent of the company's shares are owned and operated by a family. This situation is not much different from other countries such as Spain (La Porta et al., 1999). Arifin (2003) states that the advantages of a family owned and operated company are family members will manage the company and this will reduce agency problems. However, because a family is also a manager of the company, the agency problem will arise between the family, as a majority shareholder and a minority shareholder. In addition, according to Allen et al. (2011) bank capital also affects the performance of a bank. Due to the large capital of private banks in Indonesia issued by individuals or families, they have higher incentives to monitor loans issued due to bank performance and their wealth will be affected by repayments

Government-owned companies may not be efficiently managed because the board and management do not hold any shares in the company. This causes the company's performance to be affected (Megginson, et al, 1994; Megginson & Netter, 2001). The agency problem in the context of government ownership is more complicated as the government holds shares in the company on behalf of the public or the people. Since governments are led by politicians who have no ownership in these companies, they may not monitor the actions of the board of directors or management. In addition, the objective of a politician who leads a government may differ from an individual who owns a business. Shleifer (1998) and La Porta et al. (2002) states that governments tend to meet political goals that may negatively affect the financial performance of the company. This view is supported by Paskelian (2006) and Xu and Wang (1999) stating that the company becomes inefficient due to an agency problem arising from government political motives. In addition, government-owned banks may have lower profits because they finance a project that does not bring financial gain but brings social benefits.

The existing studies have proved that poorer loan quality and high NPLs are mainly associated with government owned banks (Berger et al. 2005 and Iannota et al. 2007). Iannota et al. (2007) also concluded that privately owned banks are more profitable than government owned and mutual banks. They also found that among mutual, private and public banks, publicly owned banks has the highest NPLs and bad loan quality whereas mutual banks has lowest NPLs and high quality loans. Furthermore, Micco et al. (2007) have found that privately owned banks has the better performance than all other banks in developing countries. They also find that the state owned banks have higher costs and lower profitability as compared to the private banks, whereas opposite is the case for foreign owned banks.

De Nicolo (2001) and Iannota et al. (2007) have suggested that state-owned banks typically exhibit higher risk than other types of banks. Micco et al. (2004), analyze financial institutions with different ownership types covering 119 countries. He concludes that non performing loans tend to be higher for

banks with state ownership than for other groups. Hu et al. (2004) use a panel of Taiwanese banks and find a positive correlation between capital share owned by the state and the level of non-performing loans. However, Garcia-Marco and Robles-Fernandez (2007) investigating the relationship between risk taking and ownership structure document that commercial banks (mainly private owned) are more exposed to risk than deposit banks (mainly state owned).

Ahmad (2013) investigate of commercial banks currently operating in Pakistan. Currently there are 30 commercial banks operating in Pakistan which can be divided into three broad categories i.e., public sector, private sector and foreign banks. The studies have found the positive association between NPLs and publically owned or dispersed ownership (Shleifer and Vishny, 1986; Berger et al., 2005; Iannota et al., 2007; and Nichols et al., 2009).

Tehulu and Olana (2014) investigate the bank specific determinants of credit risk of Ethiopian commercial banks. For this reason causal research design was applied in this study since the objective is to assess cause effect relationship. The sample consists of a panel of ten (10) commercial banks that were registered before 2007 from around 19 banks operating in the country. The period 2007-2011 was chosen just to examine the determinants of credit risk using recent data and recently established banks were not considered to avoid new entrant bias. The studies have found the ownership has a impact on credit risk. This finding shows that government banks were more risky than private banks.

Boudriga et al. (2009) investigate The aggregate banking, financial, economic, and legal environment data for a panel of 59 countries over the period 2002-2006. It develops a comprehensive model to explain differences in the level of NPLs between countries. To assess the role of regulatory supervision on credit risk, the paper uses several interactions between institutional features and regulatory devices. The studies have found The government property are positive and significant, which indicates that state-ownership rises the level of problem loans. This could be explained either by the development mandate given to state-owned banks, especially in developing countries, or by their weaker credit recovery capacities. These combined effects lead to higher credit risk taking and to increased defaults. This result corroborates those of Micco et al. (2004) who conclude that NPLs tend to be higher for state-owned banks on a panel of emerging countries.

## METHODOLOGY

The population in this study as many as 13 sharia banks but due to the limitations of the completeness of the data then the sample in this study 7 Sharia Banks period 2012-2016. The data are taken from banks' annual reports. In this study using panel data and using pooled ordinary least square (OLS). To test if Islamic Banking Unit influences performance of banks, the following model is estimated:

$ROA_{it} = \beta_0 + \beta_1 NFLMUD_{it} + \beta_2 NFLMUS_{it} + \beta_3 * DGOV_{it} + e_{it}$

Where *i* refers to the bank, *t* refers to the years:

Penjelasan:

| | | |
|---|---|---|
| $ROA_{it}$ | : | Return on assets of bank *i* in period *t*, |
| $NFLMUD_{it}$ | : | Non Performing Financing mudharabah |

| | | |
|---|---|---|
| $NFLMUS_{it}$ | : | Non Performing Financing Musyarakah |
| $DGOV_{it}$ | : | Dummy variable taking the value 1 for government bank and 0 for otherwise bank. |

## RESULTS AND DISCUSSION

**Table 1. Comparisons of Mean of Selected Variables between Different Systems of Banks**

| Ratios | Means all bank (%) | Means (%) | p-Value (2 tailed) |
|---|---|---|---|
| ROA | 0.600 | | |
| Private banks | | 0.839 | Ns |
| Government banks | | 0.421 | |
| | | | |
| NFLMUD | 2.534 | | Ns |
| Private banks | | 2.565 | |
| Government banks | | 2.511 | |
| | | | |
| NFLMUS | 3.513 | | ns |
| Private banks | | 2.797 | |
| Government banks | | 4.051 | |

a,b,c, or ns shows that the mean difference of a variable between private and government banks is significant at either 1%, 5%, 10%, or not significant at all. Table 1 shows the average ROA of all sharia banks of 0.6%. The ROA of private sharia banks is higher than the shariah banks owned by the government ie 0.839% and 0.421% respectively. there is no significant difference in the ROA of sharia banks owned by the private sector with government property. Average NFL mudharabah Islamic banks amounted to 2534%, there is no significant difference NFL mudharabah sharia private banks with government property. Meanwhile, NFL musharakah is higher than the average NFL musharakah that is equal to 3,513%. nor is there a significant difference between the NFLs of private sharia banks and government property even though the NFLs of Islamic banks are higher than those of private-owned banks. Higher NFL musharakah compared with NFL mudharabah due to poor understanding of the nature of business customers. Less customer financial evaluation, sales projection does not take into account business habits and less take into account the aspect of competitors. Insufficient evaluation of the customer account. Rarely visit the customer's project site so that side streaming and customer problems can not be detected early on. On the customer side there are still dishonest, increasing consumption patterns and excessive lifestyle. unprofessional management. Unable to solve business problems, not mastering projects and losing out in competing.

**Table 2. Ordinary Least Square Result Dependent Variable: ROA**

| Variable | Ordinary Least Square | |
|---|---|---|
| | Coef. | p-value |
| Constan | 1.960 | 000*** |
| NFLMUD | -.219 | .050** |
| NFLMUS | -.229 | .001*** |
| DGOV | -.575 | .527 |
| R-squared | 0.542 | |
| Adjusted R-squared | 0.513 | |
| Prob > F | 0.0000 | |
| Number observation | 35 | |

*, ** and *** denote significance at the 10%, 5% and 1% level, respectively, p-value in parentheses

The result of regression method above shows variable of NFLMUD and NFLMUS have significant effect on ROA. These results indicate that the two variables play a significant role in determining the level of ROA in sharia banks in Indonesia by 51.3%.

NFL MUD and NFL MUS have a negative effect on ROA. it indicates that the loss of income opportunity (income) from the credit given, thus reducing the profitability and adversely affect the profitability of banks. NPLs in sharia banks result in banks having to provide large write-off of accounts receivable, so the ability to give credit becomes very limited and if uncollectible it will result in losses. Second, liquidity is the problem of high mobility of public funds so that banks have to do stimuli such as high profit-sharing rate in order to recover community funds back. This finding supports information asymmetry theory and bad management hypothesis which argues that NPL is the result of adverse selection, and is linked to management inability to control operating efficiency which in the run run leads to decrease in profitability. Therefore, the results support the higher the nonperforming loans, the lower the ROA. The results are consistent with the findings of Kithinji (2010), Kargi (2011), Kolapo et al. (2012), Muhammad et al (2012), Samuel et al. (2012), Madishetti, and Rwechungura (2013) and Kingu et al (2018).

## CONCLUSION

The purpose This study to analyze the effect of Non Performing Financing mudharabah financing and musyarakah financing and bank ownership of profitability at Sharia Commercial Bank. The results showed that Non Performing Financing Mudharabah financing and Non Performing Financing Musyarakah financing have a significant negative effect on Profitability (ROA). The results of this study indicate that there are non-performing loans that can reduce the profitability of sharia banks in mudharabah and musyarakah financing although the amount of funding is very small compared to murabahah financing. NFL MUD and NFL MUS have a negative effect on ROA. it indicates that the loss of income opportunity (income) from the credit given, thus reducing the profitability and adversely affect the profitability of banks. NPLs in sharia banks result in banks having to provide large write-off of accounts receivable, so the ability to give credit becomes very limited and if uncollectible it will result in losses. Second, liquidity is the

problem of high mobility of public funds so that banks have to do stimuli such as high profit-sharing rate in order to recover community funds back.While the variable ownership of the bank does not affect the profitability of sharia banks.

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