# RATE OF PROFIT AS A PRICING BENCHMARK IN ISLAMIC BANKING TO CREATE FINANCIAL STABILITY

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## THE BACK GROUND

The Application of the concept of rate of profit as a replacement of the rate of interest concept (interest rates) as a consequences of the abolition of interest in the Islamic banking and capital markets sharia system is often facing a problem in the field because there is no yardstick (benchmark) in determining the profit margin on the contract of sale like *Murabaha* and the rental costs on the contract of leasing like *Ijara* in Islamic banking transactions or on Islamic bonds transactions.

- As a result, the entire applications of *riba* in Islamic financial institutions like the 4-type of interest rate concept i..e. simple interest, compounded interest, fixed interest, variable interest which are all determined in advance (predetermined), are all applied in Islamic Banking Products especially trade and leasing based financing like *Murabaha* and *Ijara*. Nowadays Islamic banks in the financial-center around the world are still using the LIBOR (London Inter-Bank Offered Rates) which is the average lending rates of the largest banks in London as a benchmark in quoting rate of profit to their products therefore it creates same risk profile as conventional banks. In Indonesia, Islamic Bank use Central Bank Certificate benchmark (SBI) + 5 % in their financing price.
- The concept of rate of profit as a substitute for the concept of rate of interest is very important in Islamic Finance Theory, because it plays a very central role in assessing the price of any financial assets. In conventional finance, financial asset prices, especially bond (including sharia bond) is largely determined by the rise and fall of interest rates. If interest rates rise, the prices of financial assets with fixed interest (fixed coupon rate) like Murabaha will automatically fall, because the value of the present value or the current price of the assets are valued based on the discounted value of the cash flow of money to come, whereby interest rates is used as a measurement.

# THE DEBATE AMONGST ISLAMIC ECONOMIC THINKER EMPHASIZE THE IMPORTANCE OF THIS RESEARCH

#### PRO

### Yahia Abdul Rahman

Islamic Benchmark determination by using the methodology of *mark* to the market and real market index (In The Art of Islamic Banking and Finance : Tools and Techniques for Community Based Banking )

#### Masudul Alam Choudhury

Rate of profit and real sector are related positively and to be an equilibrium factor for monetary system (In General Theory of Islamic Development Financing)

### Mohsin S. Khan

Rate of profit of financial asset are determined by the *rate of return* in real market. (In Journal "The Financial System and Monetary Policy in an Islamic Economy")

## CONTRA

### Muhammad Taqi Usmani

The use of LIBOR as a benchmark in Islamic Product is not making the transaction as haram (In *Introduction to Islamic Finance*)

### Mahmoud El-Gamal

Islamic benchmark unnecessary, impractical and dangerous and not deep enough and did not have good liquidity to form a uniform rate (In Islamic Finance: Law, Economics and Practice

Hosein Askari, Zamir Iqbal dan Abbas Mirakhor

*Benchmark* can be determined in Money and Capital Market Indicator (In *New Issues in Islamic Finance and Economics, Progress and Challenge* )

# ECONOMIC THOUGHTS FROM CONVENTIONAL TO ISLAMIC THINKER TO DETERMINE THE PRICE OF FINANCING

Pierro Sraffa To calculate the agregate *rate of profit* we can use the Gross Domestic Product (GDP)

(In Production of Commodities by Means of Commodities: Preclude to a Critique of Economic Theory)

### Salman Shaikh *Rate of profit* has to be benchmark against nominal GDP.

(In Corporate Finance in an Interest Free Economy : Alternate Appraoch to Practiced Islamic Corporate Finance)

Kadim As Sadr *Rate of profit* is determined as a ratio Of Deffered Price by The Cash Price in Real Market

(In Money and Monetary Policies in Early Islamic Period" in Essays on Iqtisad: Islamic Approach to Economic Problems) THE THOUGHT OF RATE OF PROFIT AS A BENCHMARK FOR ISLAMIC ASSET PRICING :

**GDP + OHC + ROA** 

excluding Risk and Term Premium like Conventional Bank practice

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# THE MAIN CRITICAL ISSUE



## THE PROBLEM IN ISLAMIC FINANCIAL MARKET CURRENTLY WHICH MAKE THIS RESEARCH IS VERY IMPORTANT AND RELEVAN



The applicative concept of Rate of Profit practiced in Islamic Financial product are more expensive, create unstable distribution of income and even reduce wealth measured by the asset value so that the purpose of Islamic Economic to create social welfare is not achieved

The Determination of the Rate Of Profit in Islamic Financial Product is the key to create economic justice (not exploitative) and create stability in equal distribution of income and wealth in line with the purpose of the Sharia (maqashid sharia)

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# THE OBJECTIVE OF THE RESEARCH

This study aims to find the concept of rate of profit on Islamic banking that can create economic justice and stability in Islamic Financial Market (Banking and Capital market) by looking at its current practice. Rate of profit that creates economic justice and stability can be achieved through its role in maintaining the stability of the financial system in which there is an equitable distribution of income and wealth (in line with the purpose of sharia or maqashid sharia)

To determine the role of the rate of profit as the basis of the sharing system implemented in the Islamic financial system, we can see the connection of rate of profit in creating financial stability, especially in the asset-liability management of financial institutions that generate a stable net margin or the rate of profit that is not affected by the ups and downs of the market risk factors including indirect effect on interest rates. Furthermore, Islamic financial stability can be seen from the role of the rate of profit on the stability of the Islamic financial assets value that are measured from the Islamic financial asset price volatility in Islamic Financial Market

# THE KEY MEASUREMENTS

# MACRO

MICRO

Maqashid Shari'ah The Purpose Of Islamic Economy (Economic Justice) Equal and stable distribution of income and wealth

THE AIM

The stability in Islamic Financial Market as measured by the Stable Net Income of Banking System and Asset Value of Islamic Financial Product

# **RATE OF PROFIT CONCEPT : IDEAL VERSUS REALITY**

NO	MEASUREMENT	IDEAL	REALITY
1	The purpose of Syariah Economic (Maqashid Syariah)	Equal and Stable Distribution of Income and Wealth to Create Maslahah (Welfare)	In General the distribution of the investment income in Islamic Financial Market are more in favor of capital owner and Islamic asset value more volatile
2	Macro Economic Maslahah	Stability in Islamic Financial Market	Islamic Banking Income and Asset Value are more fluctuate and not stable
3	Micro Economic Maslahah	Islamic Asset Pricing that are not exploitative and create justice	In general the distribution of income are more profitable for capital owner as the bank uses time value of money instead of economic value of profit concept

## THE ELIMINATION OF RIBA AND MAYSIR IN THE RATE OF PROFIT CONCEPT

TYPE	THE CAUSE	ELIMINATION METHOD	
Riba Nasi'ah	The application of the Time Value of Money in Sale Based Islamic Banking Product (annuity system) like Murabaha which in favor of the capital owner	The application of The Economic Value of the Asset according to the rate of profit in real market (Proportional System)	
Riba Fadl	The application of the component of the cost of fund instead of the profit in good markets	The application of mark to the market method according to the rate of profit in real market	
Maysir	The application of additional term premium component fixed for long term transaction like rate of interest concept	The application of Profit Adjustment according to the profit in real market so that reducing the duration of asset as a stability factor in Islamic Financial Market	

### SELECTION TECHNIC TO AVOID SPECULATION (MAYSIR) BASED ON RATE OF PROFIT CONCEPT

Term	Type of Transactions (Aqad)	Rate of Profit
Short Term (<2 years)	Murabahah, Salam	Once, Proportional
Medium Term (2-5 years)	Istishna, Ijarah, Mudharabah, Musyarakah	Cyclical, Repricing
Long Term (>5 years)	Ijarah Muntahia Bi Tamlik Musyarakah Mutanaqisah	Cyclical, Repricing

## The Previous Study on The Rate of Profit Stability of Islamic Bank

- Abdel Hamid M. Bashir from Department of Economy Grambling State University conducted a study of the Determinants of Profitability and Rate of Return Margins in Islamic Banking; Some Evidence From Middle East (2000).
  - The results of the study as a whole is: there are influences on the ratio of short-term funds, non-earning assets and operating costs, as well as capital adequacy and financing ratios, but the research did not include the factor of balance sheet structure (Rate Sensitive Asset-RSA/Rate Sensitive Liabilities-RSL)
- Martin Cihak and Heiko Hesse from International Monetary Fund (IMF) on the Profit Stability of Islamic Banks in 77 Countries (2008)
  - In the studies, it were not explained clearly why the causes of the instability of the studied Islamic banks. According to the authors, the difficulty of the change was particularly difficult to change the structure of assets and liabilities (RSA/RSL) most of which have a rate of profit that is permanent in long-term, that causing a decrease in the parameter profit of μ due to the changes in the market variables (interest rate) that affects indirectly the liabilities in the form of increased demand deposits yield of *mudharabah*
- Amine Abi Aad dan Elias Raad from Lebanese American University on the Profit Efficiency of Islamic Bank as Compare to Commercial Bank in the Middle East (2009)
  - studied between the years 2003-2007, especially in the countries of the Middle East, namely in Bahrain, Jordan, Kuwait, Lebanon, Qatar, Saudi Arabia, Syria, United Arab Emirates and Yemen to the conventional 83 banks and 20 Islamic banks are the mean average net profit in Islamic Bank is lower by 3% compared with the net interest margin at conventional banks which approximately 6%. According to the author, this happens because between the 2003-2007 period there was an increase in interest rates in general, so that under consideration that many assets transactions are done with *Murabahah* scheme

# **Research Model**

The Study Case is used on this research and the author used the secondary data retrieved from the data of rate of profit that is called The Net Margin (NM) of Bank Syariah Mandiri (BSM) from year 2004 to 2009 (5 years). The period is selected due to the ideal condition for this research where there is a period of rising interest rates.

To find the concept of rate of profit that creates economic stability, the use of quantitative research to see the effect of interest rate volatility as represented by the SBI (along with other factor such as the structure of the balance sheet) to The Net Margin (the rate of profit of Islamic Bank) in the BSM for 5 years i.e. 2004-2009 is being conducted.

# **The Research Model**





P j = asset-liability repricing date in 1 year

### The Research Model

### The Role of Rate of Profit in Creating Equitable Distribution of Wealth as Measured by the Volatility of Asset Value of Islamic Financial Product

- The volatility of Asset Value can be derived : (dV/V) = -n (dR/1+R)
- The risk of financial instability in the bank's value can be measured by the volatility of portfolio net worth (PNW) per market value of asset that had been managed as below :

 $d(PNW/A) = -dG \cdot dR + CG/2 \cdot dR^2/(1+R)$  whereby  $CG = CA - (L/A) \cdot CL$ 

 CA = Convexity Asset, CL = Convexity Liability, A = Market Value of Asset, L = Market Value of Liability, D = Duration and R = Rate of Return

# **Quantitative Research Model**

• The model used is a model with multiple regression analysis to determine the effect of 5 Factors i.e. : Balance Sheet Structure of Islamic Bank represented by the ratio of RSA/RSL (Rate Sensitive Assets / Rate Sensitive Liabilities), Islamic Bank Investment in Real Sector represented by the ratio FDR (Financing to Deposit Ratio), Interest Rate represented by the SBI (Bank Indonesia Certificate), Islamic Bank Capital represented by the CAR (Capital Adequacy Ratio) and Islamic Bank Credit Default represented by the NPF (Non Performing Financing) to rate of profit of Islamic Bank represented by the Net Margin to Deposit (NM) of Bank Syariah Mandiri. From the research results shows that the Net Margin of Islamic banks turned out to get affected by the interest rate movement. In this research we are using the interest rate of SBI (Bank Indonesia Certificate) as a comparison. Research models also illustrate the instability of BSM net margin/income to changes in interest rates, represented by the SBI and other independent factors as below:

• Net Margin =  $\alpha + \beta 1$  RSA/RSL +  $\beta 2$  FDR +  $\beta 3$  SBI +  $\beta 4$  CAR +  $\beta 5$  NPF +  $\upsilon$ 



■ NM = 11.270 - 0.015 RSA/RSL - 0.228 SBI - 0.225 CAR

•	t	(30,285)	(-3,272)	(-10,072)	(-8,405)
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- se (0.372) (0.004) (0.0023) (0.027)
- $R^2 = 0.801$

• From the above model it can be interpreted that every 1% increase in the SBI rates will cause a decrease in the rate of profit amounted to 0.228% of BSM. From this empirical data it can be concluded that the nature of the instability of Islamic banks to interest rates hike with the condition of the Islamic Bank Balance Sheet Structure (RSA / RSL) below zero (negative gap) will produce the same risk with conventional banks, namely the decline in the rate of profit of Islamic banks. In other words that the rate of profit character of Islamic banks is the same as the character of NIM (Net Interest Margin) of Conventional Banks with the Interest Rate System.

• Therefore the rate of profit in Islamic banks and Islamic bonds in the capital market should refer to the Islamic Benchmark referring to the profits in the real sector which inherently have low duration (volatility) as it will bring stability to the economy both in the banking system as well as the Islamic capital market.

## CONCLUSION

- The rate of profit in Islamic Bank that creates an equitable distribution of income as measured by the stability of the Net Margin on Asset-Liability Management of Islamic banks, can be achieved by separating the management of Islamic banks profit repricing profile based on short-term assets (*Murabaha, Istisna* and *salam*), medium term investment (*Ijara, Istisna*) and long-term partnerships (*Mudaraba, Musharaka*). If the Asset-Liability Management in Islamic Banking follows the concept of an Islamic Rate of Profit, The Net Duration of Islamic Bank balance sheet will be approach to zero or risk neutral so that it will be immune to the changes in market variables such as interest rates.
- The rate of profit that creates an equitable distribution of wealth in the Islamic capital market can be seen from the volatility of financial assets such sharia Islamic bonds (*sukuk*) that is more stable when using the concept in accordance with Islamic principles. From the economic analysis, we can see the main factor is a component of risk premium being added in the pricing structure of Islamic financial assets such as Islamic bonds which is basically the same additional charged on the loan pricing structure for compensation due to the credibility of the borrower's. This risk premium along with the long term premium structure creates price volatility which comes from high duration factor. With the concept of rate of profit which is accordance with Islamic principles, the rate of profit will be corresponding to the profit in the real sector and has always adjusted to the changes in the price in the real market (mark to the market) so that the price of the *sukuk* will be more stable.