Revisiting Mudharabah Investment Account and Proposal for Improvement – Case of Indonesia

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Abstract. The rapid growth of Islamic banks is accompanied by various innovations in Islamic financial transactions which generally seem to follow the product diversity and risk profile of conventional banks. This innovation is also carried out in the application of mudharabah particularly in the Profit-Sharing Investment Account (PSIA). Mudharabah, whose original form is equity, has been adapted by Islamic banks by treating it just like a normal deposit whith the exception that the profit is calcualted based on a ratio, resulting difficulties to distinguish it from conventional bank deposits which are debt in nature. This research aims to evaluate the implementation of mudharabah in PSIA in Indonesia, by conducting field survey and interviews with parties whom responsible for managing it and comparing it with Sharia Standard issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and fatwas of National Sharia Council of Indonesian Ulama Council (DSN-MUI). The research revealed that although PSIA return is calculated using profit distribution ratio (as mudharabah core feature), it lacks other main features of mudharabah, be it in its nature or profit or loss determination method. To rectify this deviation, this research proposes an operational model of mudharabah termed “the Quasi Equity Model", which meets the main features of mudharabah as envisaged by AAOIFI and DSN-MUI. This study contributes to the field of Islamic finance by not only identifying existing discrepancies but also proposing a practical model for addressing them, thus aligning it back to sharia principles within Islamic banking practices.

Key words: AAOIFI, mudharabah, profit sharing investment accounts, sharia compliance authority.

Abstrak. *Pesatnya pertumbuhan bank syariah disertai dengan berbagai inovasi dalam transaksi keuangan syariah yang umumnya terkesan mengikuti keragaman produk dan profil risiko bank konvensional. Inovasi ini juga dilakukan dalam penerapan mudharabah khususnya pada Rekening Investasi Mudharabah (PSIA). Mudharabah, yang bentuk aslinya adalah bersifat ekuitas, telah diadaptasi oleh bank-bank syariah dengan memperlakukannya seperti deposito pada umumnya dengan pengecualian bahwa laba dihitung berdasarkan rasio, sehingga menimbulkan kesulitan untuk membedakannya dari deposito bank konvensional yang bersifat utang. Penelitian ini bertujuan untuk mengevaluasi implementasi mudharabah dalam PSIA di Indonesia, dengan melakukan survei lapangan dan wawancara dengan pihak-pihak yang bertanggung jawab mengelolanya, serta membandingkannya dengan standar syariah yang dikeluarkan oleh* Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *dan fatwa Dewan Syariah Nasional Majelis Ulama Indonesia (DSN-MUI). Penelitian mengungkapkan bahwa meskipun imbal hasil PSIA dihitung menggunakan nisbah bagi hasil (sebagai fitur inti mudharabah), PSIA tidak memiliki fitur utama mudharabah lainnya, baik itu sifatnya maupun metode penentuan laba ruginya. Untuk memperbaiki penyimpangan ini, penelitian ini mengusulkan model operasional mudharabah yang disebut "Model Quasi Equity" yang memenuhi fitur utama mudharabah seperti yang digariskan dalam ketentuan AAOIFI dan fatwa DSN-MUI. Penelitian ini memberikan kontribusi bagi bidang keuangan Islam dengan tidak hanya mengidentifikasi*

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ketidaksesuaian yang ada tetapi juga mengusulkan model praktis untuk mengatasinya, sehingga mengembalikan kesesuaiannya pada prinsip syariah dalam praktik perbankan Islam.

Kata Kunci: *AAOIFI, mudharabah, otoritas kepatuhan syariah, rekening investasi dan bagi hasil.*

INTRODUCTION

Based on a report issued by ICD, the total assets of Islamic Banks (IBs) worldwide at the end of 2021 reached USD 2.8 trillion (ICD, 2022). The development of Islamic banking has also triggered the growth of other Islamic financial sectors, such as sukuk (capital market), asset management (mutual funds) and insurance (takaful). Total Islamic financial assets at the end of 2021 are estimated to reach USD 4 trillion. This value is equivalent to a Compound Annual Growth Rate of more than 13% in the last nine years and is estimated to reach USD 5.9 trillion in 2026 (Mirza, 2024).

Islamic banking was introduced along with the rise in ideological awareness of Muslims after being free from colonialism, when the *ulama* (Islamic scholar) realized that conventional banks operated based on interest-based lending and borrowing, which is a form of *ribawi* practice that is prohibited by sharia (Kuran, 2004; Henry and Wilson, 2004; Harahap and Risfandy, 2022). The interest is considered a form of injustice that can have a negative impact on the lives of individuals and society (Suhaib and Mahmood, 2021; Muthahhari, 1995). The concept of mudharabah was proposed as a replacement for the interest-bearing loan system, to become the operational basis of IBs (Uzair, 1955).

Initially there was a conviction that by implementing a two-level mudharabah, IBs would have a superior level of efficiency, equity and stability of the banking system compared to conventional banks (Yunus et al., 2018; Shaikh, 2013; Iqbal et al., 1998; Khan and Mirakhor, 1989; Zarqa, 1996; Khan, 1986; Ahmed, 2012). However, competitive pressures have encouraged Islamic bankers to develop financial products, which are intended to gain commercial profits, as long as these products are approved by Islamic scholars (Faisal, 2019; Oseni et al., 2016; El-Gamal, 2006). The tug-of-war between maintaining the initial ideas of Islamic banking operational principles on the one hand, and competitive pressures and various other interests on the other hand, have given rise to two polar approaches in developing Islamic banking products, namely: formalists and essentialists (Hanif and Ayub, 2022).

The formalists put forward ideas for financial transactions that in principle could be approved by Islamic scholars. Meanwhile, essentialists do not only look at formal aspects in determining the permissibility of a transaction, but also consider the motives and actual impacts that may arise from the transaction (Hanif and Ayub, 2022). The evolution of Islamic banking products and operational models has developed in such a way that perceptions are growing up that current Islamic banking practices are resembling conventional banks, and only differ in the terminology (Qazi et al., 2020; Rosly and Zaini, 2008). Product development is carried out by seeking justification from *fiqh* (Islamic jurisprudency) perspective or what is known as *hiyal* (legal stratagems) (Syed and Omar, 2017; El-Gamal, 2006). If this continues, it is feared that it could threaten the credibility and sustainability of Islamic banking (Jan, 2018; Djuitaningsih, 2018; Ali, 2017; Chapra, 2014).

One of the fundamental problems regarding Islamic banking practices that has received sharp criticism is the application of mudharabah in mobilizing funds (Aqeeq, 2015; Devi, 2024). The use of mudharabah as an operational pillar of IBs which initially was formulated (among others) by Uzair (1955), Al-Arabi in Migdad and Dawaba (2022), and Siddiqi (1983), underwent evolution in such a way that it became the form known today. This evolution occurred in line with a shift in the development of Islamic banking products, from initially being in the hands of *fuqaha* (plural of *faaqih*, means; *fiqh* expert) and economists, now moving into the hands of bankers who are generally former conventional bankers (Ahmed, 2011). Problems related to the use of mudharabah in funds mobilization and caused by it’s evolution include the following aspects:

1. Governance (Majeed and Zainab, 2021; Nienhaus, 2007; Archer and Karim, 2009)
2. Justice (Zakarneh, 2023; Diaw and Mbow, 2011; Fadhilah and Tohirin, 2021)

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3. Transparency (Lahrech et al., 2014; Alaeddin et al., 2017)
4. Consumer protection (Grais and Pellegrini, 2006; Lukonga, 2015).

Currently, there is no uniformity regarding how IBs treat mudharabah and procedures for sharing profits (Alhammadi et al., 2018). This results in incomparability of financial reports between IBs and creates confusion in their regulation (Archer and Karim, 2009). This research is an effort to evaluate the conformity of mudharabah practices in mobilizing funds carried out by Indonesian IBs (IIBs), with the mudharabah concept, especially as guided by AAOIFI sharia standards (AOIFI) and DSN-MUI Fatwa (DSN-MUI). The rest of the paper is arranged as follows. Section 2 reviews the literature on the essence of mudharabah as a corner stone of Islamic banking operation and adaptations made to serve commercial banking mode of operation. Section 3 explains the qualitaive method used in this research. Section 4 enumerates the result of the research on how actually IIBs treat mudharabah contract and translate it into profit distribution procedures. At the end of section 4, the authors also propose some remedial measures to align back the current practice of mudharabah to its mudharabah core principle. Section 5 concludes the paper.

LITERATURE REVIEW

Fiqh of Mudharabah

Mudharabah cooperation is not something that is known based on revelation, but it was commonly practiced by the Arab people before the prophetic period (Udovitch, 1965). Mudharabah is allowed because it does not conflict with the sharia objective and because of that the Prophet PBUH practiced it (al-Sarakhsi, as quoted by Mughal, 2012). One of the arguments on which mudharabah is permissible is a hadith delivered by Suhayb (r.a).: “Three matters that have the blessing of Allah i.e. a deferred sale, muqaradah/mudharabah, mixing the wheat and barley for domestic use and not for sale” (Sunan Ibn Majah).

Mudharabah in *fiqh* is defined as a cooperation between capital owners *(shahibulmaal)* and entrepreneurs *(mudharib)*, where *shahibulmaal* entrusts the management of his capital to *mudharib* without *shahibulmaal's* interference in managing the business; profits generated from the business then will be shared between both parties according to the pre-agreed sharing ratio, and if losses occur, they will be borne by *shahibulmaal* (Zuḥaylī, 2007; Shamsudin et al., 2015; Rahman, 2018; Yunus and Muhit, 2023). The mudharabah contract does not result in the transfer of ownership rights to capital or assets financed by mudharabah funds from *shaibulmaal* to *mudharib* (Mughal, 2012; Rahman, 2018). This is in line with the opinion of Ibn al Qayyim who said that *mudharib* is a trustee when he takes money, employee in the work he does, representative when he uses it, and partner in profits (Al-Jauziyah, 2016).

The main elements of mudharabah are as follows (Tahrim et al., 2018; Mughal, 2012):

a. The parties and their respective rights and obligations
b. Mudharabah capital
c. Duration
d. Profit sharing ratio

The parties and their respective rights and obligations

There are two parties involved in mudharabah, namely capital owners (*shahibulmaal*) and entrepreneur *(mudharib)*. In general, the *shahibulmaal* is obliged with providing capital, while the *mudharib* is tasked to run a business to make a profit, either with or without restrictions set by the *shahibulmaal* (Aziz and Abbas, 2013; Tahrim et al., 2018).

It is believed that the reason behind the permissibility of mudharabah is because the contract is considered to provide justice for the parties involved and avoids the exploitative nature of lending and borrowing transactions with interest (Shadr, 2008; Sjaiful et al., 2022). Profit sharing in mudharabah is based on the legal maxim which reads: *al-ghunmu bi ‘l-ghurmi*, meaning that a person has the right

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to obtain profits in accordance with the risks borne (Shaikh, 2013; Dusuki, 2014). This rule is derived from the hadith of the Prophet which was narrated by al-Tirmizi, Abu Dawud, Ibn Majah and Ahmad which reads: *al-kharraj bi 'l-dhiman* (Sharif, 2013; Azrak and Hazaa, 2021) which can loosely be interpreted: the permissibility of obtaining results from something is due to the responsibility (for potential losses and costs) that accompanies it.

Shahibulmaal is responsible if there is a loss arising from business risks (up to the amount of his capital contribution), while *mudharib* will lose his time and energy (Usmani, 1999; Muladi et al., 2018). However, if the loss is caused by negligence or moral hazard, then the *mudharib* must be accountable (Sapuan, 2016; Herijanto, 2016). All *ulama* agree on the prohibition of guaranteeing the principal of mudharabah funds.

Maliky and Syafi'y *ulama* agree that mudharabah should not be restricted, in order to encourage entrepreneurs to look for more opportunities to get better profits. However, Abu Hanifah and Ahmad Ibnu Hanbal allow restriction certain aspects of the mudharabah contract, for example the duration and risky activities (Zuḥaylī, 2007).

Islamic banking operational model with a two-tiers mudharabah scheme was first put forward by Al-Arabi in 1966 (Ariff, 1988). Based on this scheme, banks will have a dual role, namely: as *mudharib* when receiving capital from *shahibulmaal*, and then as *shahibulmaal* when channeling funds to be used by entrepreneurs (ultimate *mudharib*) in real sector business activities. The majority of *fuqaha* state that *a mudharib* is not permitted to carry out two-tiers mudharabah, without the consent of the original *shahibulmaal* (Borhan and Sa'ari, 2007; Rahman, 2018).

Mudharabah capital

Most of *fuqaha* opin that capital must be in cash (Usmani, 1999) that must be handed by *shahibulmaal* to the *mudharib* before the *mudharib* starts his business (Ishak and Rahman, 2021; Aziz and Abbas, 2013). Most *fuqaha* do not allow the use of non-monetary assets or goods as capital, because it can create uncertainty in determining the value of capital. In addition, fluctuation in non-monetary investment prices can cause unfair profits and losses between contracting parties (Sapuan, 2016). Most of *fuqaha* also agree that capital should not be in the form of a loan from the prospective *mudharib* to *shahibulmaal* (Zuḥaylī, 2007).

Duration

According to Zuhayli, scholars of Hanafy, Hanbaly and Shafi'y agree that one party can terminate the contract at any time (Zuḥaylī, 2007). A different opinion was expressed by Maliky scholars who emphasized that once work begins, the contract becomes binding on both parties. However, if both parties agree that each party will not stop cooperation for a certain period of time, except in certain circumstances, then this is not considered a violation of sharia principles. This opinion is based on the hadith which says: "All the conditions agreed upon by the Muslims are upheld except a condition which allows what is prohibited or prohibits what is lawful." (Usmani, 1999; Ishak and Rahman, 2021). If one of the parties dies, the contract can be passed on to his heirs (Sapuan, 2016).

Profit sharing ratio

Profit sharing ratio, upon which distribution will be made, must be determined before the start of the collaboration (Usmani, 1999). The share of each party cannot be determined in the form of a nominal value or a certain percentage of capital. Mudharabah cooperation is allowed to use several ratios, where the profit-sharing ratio is determined differently for different conditions (Aziz and Abbas, 2013). All goods purchased by the *mudharib* with funds originated from the *shahibulmaal*, are the sole property of the *shahibulmaal*, and the *mudharib* is entitled to a share of the profits only if he sells the goods profitably. Therefore, he has no right to claim his share of the mudharabah assets, even though their value increases (Usmani, 1999).

Profit/loss determination

Fuqaha are of the opinion that the profit/loss of mudharabah cooperation can only be determined by liquidating the mudharabah assets, known as *tandeed* (Napier, 2007). Profit is determined based on

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the cash difference between the capital provided at the beginning of cooperation and the remaining money after all the merchandise is sold and debt si settled (Aziz and Abbas, 2013). If at the end of the collaboration there are all non-cash assets (including debts and receivables) then the *mudharib* must be given sufficient time to liquidate them, so that the actual profit/loss can be determined (Usmani, 1999). If the cash obtained is less than the initial capital, the *mudharib* will not get anything. If the principal amount cannot be returned in full, then the profits that had been shared by the *mudharib* and *shahibulmaal* during the mudharabah period will be collected back to pay the principal to the *shahibulmaal*, and the remaining balance (if any) will be the profit which will be distributed to the *shahibulmaal* and *mudharib* (Aziz and Abbas, 2013).

Adaptation of Mudharabah for Commercial Bank Operations

Considering the differences between classical mudharabah and the nature of commercial banking business, Islamic banking practitioners together with *fuqaha* have made various adaptations to classical mudharabah theory in order to meet the needs of banking transactions in general, and fund mobilization in particular. The funds mobilazed based on mudharabah agreement usually termed as Profit Sharing Investment Accounts (PSIA), and the customers as *shahibulmaal* are called Investment Account Holder (IAH). There are two types of PSIA, namely Restricted PSIA (RPSIA) and Un-restricted PSIA (UPSIA) (AAOIFI, 2017b and IFSB, 2021).

RPSIA is based on the *mudharabah muqayyadah* contract, where *shahibulmaal* restricts some aspects in the mudharabah agreement, while UPSIA is based on the *mudharabah muthlaqah* contract, where *shahibulmaal* giving liberty to the *mudharib* to run the business, including commingling the management of its funds with the *mudharib's* own funds (AlShattarat and Atmeh, 2016; Aziz and Abbas, 2013). Unless specifically stated, the PSIA referred to in this study means UPSIA.

The mobilization of Islamic bank funds is generally carried out in the form of UPSIA. Although listed as a part of on balance sheet item, at least in theory, UPSIA is not a bank's debt or capital (Atmeh and Ramadan, 2012). Accordingly, in the case of liquidation, IAHs have no claim as creditors over the assets of the IB (as do conventional depositors). However, IAH have an ownership claim as *shahibulmaal* to the net asset value of their funds, and in this respect do not rank *pari passu* with shareholders (IFSB, 2021).

Determination of shahibulmaal

In classic mudharabah, the partnering parties are static, with the *shahibulmaal* and *mudharib* remaining constant during the period of cooperation. With business activities that take place on a going concern basis, while depositors can come and go, IBs will sign mudharabah with *shahibulmaal* which from time to time change dynamically. To accommodate this, Hamoud proposed the concept of *mudharabah mushtarakah*, where IBs will make mudharabah with all current and future *shahibulmaal* (Vogel and Hayes, 1998).

Characteristics of mudharabah funds

In theory, mudharabah funds act as equity that can absorb losses (Spinassou and Wardhana, 2018). But in reality, this is not always the case. Based on a survey conducted by the IFSB in 2009, it was revealed that many IBs treat mudharabah funds like conventional bank deposits (Farooq and Vivek, 2012). Archer et al. (2010) and Sundararajan (2011) found that the characteristics of PSIAs vary greatly, ranging from those that are deposits to those that function as investment products, depending on the extent to which the risk of loss is transferred from customers to shareholders through various techniques.

The survey conducted by IFSB show that 57% of respondents consisting of financial services authorities and IBs from various countries are of the opinion that PSIA is a deposit. Meanwhile, most respondents from the financial services authority view it as an investment that can experience a loss in the principal of the placement/investment (Adewale and Archer, 2019). By paying attention to the heterogeneity of mudharabah practices in raising funds, the IFSB recommends that local financial

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authorities determine categories of mudharabah funds, whether as equity, liabilities, or something in between (IFSB, 2015).

Mudharabah presentation in financial reports

The fact that in mudharabah any party may terminate the contract, gives rise to the assumption that PSIA also has the characteristics of debt (Alaeddin et al., 2017). To overcome this, AAOIFI introduced a new post in recording mudharabah between capital and debt, called unrestricted investment. However, this separation is not carried out on the asset side. This shows AAOIFI's inconsistency in treating mudharabah (Atmeh and Ramadan, 2012). Examining the financial reports of 63 banks in 15 countries, Suandi (2017) found that the main problem with regard to recording PSIA is caused by the ambiguous nature between debt (liabilities) and capital (equity).

As previously mentioned, mudharabah does not transfer ownership of assets from *shahibulmaal* to *mudharib*. Thus, the monetary value of PSIA should depend on the value of the asset and the resulting profit/loss. Meanwhile, currently AAOIFI determines that the capital value of mudharabah must be recorded based on historical value (AlShattarat and Atmeh, 2016).

Profit sharing distribution procedures

a. **Capital Value Calculation**
   Because IBs run on a going concern basis, the banks conduct profit and loss calculation at the end of month. Meanwhile IAH can deposit or withdraw their funds at any time. Therefore, in calculating profit/loss at the end of the month, the value of mudharabah capital contribution in the total banks financing is calculated on a daily average balance (Maali and Napier, 2010). Taqi Usmani is among the ones who allows this practice. However, some *fuqaha* do not agree with this practice, since they view the influence of time value of money concept, as well as the presence of new *shahibulmaal* who join in the middle of business operation (Mujaddidi, 2017).

b. **Source of Income to be Distributed**
   In the early stages of the introduction of Islamic banking, there were two different opinions regarding source of income to be distributed, namely between Al-Arabi and Hamoud. Hamoud believes that banks only need to share income obtained from funding activities, while Al-Arabi believes that the income to be distributed should come from all types of income received (Napier, 2007).

   Nowadays, most IBs only share the income obtained from financing. For IBs that commingle PSIA with their own funds, with regard to the risks faced by IAH, the distribution of income that only comes from financing can be questioned as to its conformity with legal maxim of *al-ghunmu bi ʻl-ghurmi*. This is not only because IBs cannot separate the sources of funds used in carrying out their other business activities, but also because IAH can be exposed to other risks, such as market risk and operational risk. Even though these two risks rarely occur, this does not mean they cannot occur, as happened in the case of the Barings bank bankruptcy in 1995 (Sarno and Martins, 2018).

c. **Profit/Loss Recognition and Profit Sharing Instruments**
   In classical mudharabah, profit/loss is calculatedat at the end of the trading mission, where all assets have been liquidated *(tandeed)*. The difference between the value of the money handed over and the money generated at the end of the mudharabah period becomes the profit or loss of the mudharabah cooperation. This mechanism certainly cannot be applied to types of banking business activities. Therefore, *fuqaha* introduced a constructive liquidation mechanism *(tandeed hukmy)* to determine the profit/loss of mudharabah, and on this basis the profit distribution will be carried out between the bank and IAH (AlShattarat and Atmeh, 2016).

   Among IBs there are differences in determining the costs that are taken into account and how to calculate profit sharing (Alhammadi et al., 2018). The mismatch between the source and use of funds, as well as the dynamic nature of placement and withdrawal of funds that is

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characteristic of commercial banks, makes it difficult for IBs to determine the costs that will be deducted from income as a basis for profit distribution. In this regard, some IBs implement profit sharing (such as banks domiciled in Qatar and the United Arab Emirates), revenue sharing (such as IBs in Indonesia, Jordan and Bahrain), or something in between (such as IBs in Pakistan) (Lahrech et al., 2014; Ayub and Ibrahim, 2013).

Even though there is an agreement that the distribution of profit is based on a ratio, in practice several IBs also apply weightages as an instrument to value the placement tenor (Mujaddidi, 2017). For funds with a longer placement period, greater weight will be assigned.

d. Benchmarking

Based on research on IBs in Malaysia between 1995 and 2004, Chong & Liu (2009) using the Engle-Granger error correction model, found that changes in conventional bank deposit interest rates cause changes in Islamic investment returns, but not vice versa. Meanwhile, the use of VAR models and their variants, such as structural VAR and cointegrated structural VAR or VECM, is usually used to test certain theories or concepts against empirical data. This method can also be used to examine the extent to which the mudharabah concept has been implemented and how the results are reflected in empirical data (Siregar, 2001).

For the case of Malaysia, Anuar et al. (2014) using data from Bank Negara for the 1994-2012 period and the VAR method shows that conventional bank interest rates influence Islamic bank returns, and not vice versa. Similar results were also reported by many researchers such as Hamza on 60 IBs from various countries (Hamza, 2016) and Kasri and Kassim (2009) for Indonesia.

However, different results were reported by Yusof et al. (2015). Apart from using the Granger causality test, in their research Yusof et al. also uses vector autoregressive (VAR), by adding several other variables, such as the Consumer Price Index. Yusof et al. found that returns on Islamic bank mudharabah deposits in the Gulf countries cannot be considered to be significantly influenced by conventional bank deposit interest rates. Given these differences in findings, Yusof et al. suggested that direct (field) research should be carried out on how IBs actually determine PSIA returns, and when using benchmarks, what values refer to this.

e. Profit Distribution Management

Concern on the competitiveness of IBs in attracting deposit using mudharabah has been expressed by Fahim (1983) since the first decade of the introduction of Islamic banking. Therefore, economists, practitioners and *fuqaha* are trying to formulate ways that can protect customers from losses. One of the proposed methods is through the formation of reserves that are set aside when IB financing yields high return to compensate whenever situation is reverse. From the responses AAOIFI received during the concept exposure period regarding capital adequacy provisions, it was revealed that income smoothing for depositors is widely practiced and recognized as a normal feature of Islamic banking (Archer and Karim, 2006). Baldwin et al. (2019) emphasize that income smoothing is carried out by IBs in various jurisdictions.

Apart from establishing reserves, protection of returns and principal of mudharabah funds is also carried out using a *hibah* (grant) mechanism (Ayub and Ibrahim, 2013; Alhammadi et al., 2018). This means that the bank has sacrificed its share of profits to give it to customers (known as Displaced Commercial Risk /DCR). A study on IIBs show that there is DCR in all IIBs deposit products (Hasanah et al., 2013). By considering the DCR faced by IBs, the IFSB introduces α (alpha) factor which determines the amount of risk-weighted assets which is also included as the denominator in Capital Adequacy Ratio (CAR) calculation, with a value range from 0 (zero; which means PSIA is treated as an equity) to 1 (one; which means PSIA is a liability) (IFSB, 2021).

The use of PER by IBs has drawn a lot of criticism from legal experts and economists. The use of PER is considered to cause injustice (Shaharuddin, 2010; Atmeh and Ramadan, 2012),

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reduces transparency (Agil et al., 2011) and also raises problems related to governance and customer protection (Ibrahim, 2020; Grais and Pellegrini, 2006).

In Search of the Ideal Model for the Implementation of the Mudharabah Contract in Fund Mobilizing

The enactment of IFSA by the Malaysian financial authoritiy in 2013 has indirectly challenged the operational model of Islamic banks which was initially based on the use of mudharabah contracts as a fund mobilizing instrument that allows fund owners to earn returns. Innovations in the implementation of mudharabah that were previously introduced by practitioners and shariah scholars, such as implicit principal guarantees, the use of income smoothing, the introduction of Profit Equalization Reserve and Investment Risk Reserve, were canceled. The step back to the classic mudharabah is accompanied by a pragmatic step in the use of *murabahah tawarruq* as an agreement used in fundraising.

On the other hand, DSN-MUI went further by issuing fatwa No. 105 of 2016 which allowed *mudharib* to voluntarily provide a guarantee for the return of mudharabah trees. Apart from the pros and cons of the DSN-MUI fatwa, the provision of a guarantee for the return of mudharabah capital has the potential to obscure the rights and obligations in the mudharabah contract (Devi, 2024). If this is applied in the collection of Islamic bank funds, it will further emphasize the existence of problems accompanying the implementation of mudharabah as stated by various researchers.

After discovering the phenomenon that Islamic banks in Pakistan use a weighting system in profit sharing distribution only to achieve certain rate of return targets, Shah and Siddiqui (2018) urged Islamic banking authorities in Pakistan to take steps to regulate the profit distribution system so that it is not implemented manipulatively. Kawsar et al. (2023) also proposed to improve the profit-sharing distribution mechanism in Bangladesh's Islamic banking, from originally using a weighting system to be replaced by the Income Sharing Ratio method.

Similarly, AAOIFI continues to strive to improve the rules and procedures for the implementation of mudharabah contracts in fund collection, including the profit-sharing distribution mechanism that is carried out. One of the most up-to-date events on this issue is the presentation of a proposed mudharabah implementation model for collection by Omar Mustafa Ansari (Secretary General of AAOIFI) at the IASB Islamic Finance Consultative Group meeting on May 8, 2024. Various issues related to the measurement of placement/participation value, accounting for premature exits, recognition of profit and loss, profit smoothing technique, and profit distribution mechanism were discussed in the meeting.

METHOD

As suggested by Yusof et al. (2015), this research uses a qualitative methodology in the form of a field study using a questionnaire accompanied by indepht interviews to explain the profit sharing procedure. The research began by comparing two guidelines, namely the AAOIFI Sharia Standards and the DSN-MUI Fatwa. From these two guidelines, three main conditions for mudharabah that must be met are summarized, namely: The use of *nisbah* as a profit-sharing instrument, the PSIA value reflects the value of the corresponding assets, and the PSIA funds should be treated as a loss absorber.

Just like other transactions, according to sharia, mudharabah contracts must also comply with *al-ghunmu bi 'l-ghurmi* legal maxim. From these four main criterias, 17 (seventeen) questions were derived which are expected to provide a clear picture on how IIBs treat mudharabah funds and distribute profits. In-depth interviews were conducted to clarify some issues which were conducted with officials who are directly responsible for the Asset and Liability Department of the two largest Islamic banks in Indonesia. In-depth interviews are intended to clarify the answers and obstacles that

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exist to practicing mudharabah in its ideal form. The answers of each respondent were then compared with the guidelines set by AAOIFI and DSN-MUI as well as the legal maxim in question.

Table 1 Research instrument of revisiting mudharabah investment account and proposal for improvement in Indonesia (main criteria and question)

No.	Criteria	Question
1.	Use of Ratio in Profit Sharing	What are the instruments used in profit distribution? What is the basis for determining the amount of the counter *nisbah* for mudharabah deposit? What is the mechanism for distribution of profit to each customer? If there are two customers with the same savings amount, with the same ratio, but with different placement periods will they get same amount of returns? What are the returns for customers whose new deposits are opened in mid of month and will mature in the mid of next month (while profit distribution is performed at the end of every month)? Does your bank implement income-smoothing?
2.	In determining source of distributed income, it follow the rule that the risks are commensurated with return.	What is the method used in profit distribution for mudharabah deposits at your bank (profit sharing or revenue sharing)? Are there any costs factored in profit calculation that will be shared? What are the types of income and risk taken into account in profit distribution?
3.	The value of mudharabah funds is equal to the value of the underlying assets	How is the financing value calculated? How is the mudharabah capital contribution value calculated? Is profit distributed at every month's end considered final? If the answer to prior question (No. 3 above) is: No, when and how will the profit sharing be adjusted and made final? Are mudharabah deposits treated as proof of ownership of assets, or bank deposits? Is a valuation carried out to determine the value of payments to depositors who withdraw their funds? Or is it still based on the nominal value at the time of placement?
4.	Mudharabah funds are treated as loss absorbers.	Does your bank guarantee the principal of customer's mudharabah deposits? If the bank does not guarantee the principal, does the bank create an Investment Risk Reserve (IRR)?

Source: The authors, 2024.

Respondents consisted of seven Indonesian IBs (”IIBs) with a total market share of 70.34% of total Islamic bank assets, namely as follows:

Table 2 List of respondent banks and their corresponding assets

No.	Respondent Bank	Total Assets	Share
1	BSI	320.48	39.98%
2	BMI	66.72	8.32%
3	Panin Dubai	15.96	1.99%
4	Nano Bank (formerly Bank Sinarmas-IBU)	6.89	0.86%
5	CIMB-IBU	64.32	8.02%
6	Maybank-IBU	43.29	5.40%
7	BTN- IBU	46.27	5.77%
	Total Assets of Sample Banks	563.93	70.34%
	Total Assets of IIBs and IBU (Jun 2023)	801.68	100.00%

Source: The authors (processed), 2024.
Note: IBU stands for Islamic Business Unit (in Indonesian it is called: UUS – Unit Usaha Syariah).

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Islamic banking in Indonesia does not have complete guidelines on mudharabah treatment and profit-sharing procedures. For that, each IIB conducts it based on their own understanding on several fatwas of the National Sharia Council, each of which provides guidance on certain aspects of mudharabah. The documents used to evaluate the conformity of mudharabah implementation and profit-sharing procedure carried out by an IBs in this research are as follows:

1. AAOIFI (AAOIFI, 2017b) and (AAOIFI, 2004):
   a. Sharia Standards for Islamic Financial Institutions in Safar 1439 H - November 2017 AD. No. 13 Mudarabah and Standard No. 40 Profit Sharing (AAOIFI, 2017a, 2017c).
   b. Financial Accounting Standards No. 27 (Investment Account) and No. 35 (Risk Reserve Finalization) (AAOIFI, 2014a, 2014b).
2. DSN-MUI is a fatwa issued by National Sharia Council – Indonesian Ulama Council each number:
   a. 02/DSN-MUI/IV/2000 concerning Savings dated 1 April 2000.
   b. 03/DSN-MUI/IV/2000 concerning Deposits, dated 1 April 2000.
   c. 14/DSN-MUI/IX/2000 concerning the Distribution System for Business Results in Islamic financial Institutions, dated 16 September 2000.
   d. 15/DSN-MUI/IX/2000 concerning the Principles of Distribution of Business Results in Islamic financial Institutions, dated 16 September 2000.
   e. 50/DSN-MUI/III/2006 concerning *Mudharabah Musytarakah* Agreements, dated 23 Maret 2006.
   f. 87/DSN-MUIIXII/2012 concerning Income Smoothing Methods for Third Party Funds, dated 21 December 2012.
   g. l05/DSN-MUI/X/2016 concerning Guarantee for Capital Return of *Mudharabah*, *Musharakah*, and *Wakalah Bil Istitsmar Financing*, dated 01 Ocotber 2016.
   h. 115/DSN-MUI/LX/2017 concerning Mudharabah Agreement, dated 19 September 2017.

RESULTS AND DISCUSSION

Results

Use of Ratio in Profit Distribution

1. All IIBs use *nisbah* as a profit-sharing instrument, where placement of funds with a longer term is usually given a higher *nisbah*.
2. In determining the profit-sharing ratio, apart from taking into account the returns on their respective financing, all IIBs carry out benchmarking with returns on deposits from conventional banks and competitors (other IIBs).
3. Distribution of profit is carried out in two stages. The first stage, IIB will calculate the amount of income that will be shared with IAH, which is expressed in Gross Equivalent Rate (stated in percent per annum) or HI-1000 (investment results obtained in that month for every one thousand rupiah of invested customer funds). Each method is carried out using the following formula:
   - Gross Equivalent Rate / GER (% pa.):

$$\frac{A}{B} \, x \, C \text{ x } \frac{365}{D} \text{ x } \frac{1}{A} \text{ x } 100\% \quad \text{……………………………………………………(1)}$$

   - HI-Permil / HI- 1000 (‰):

$$\frac{A}{B} \, x \, C \text{ x } \frac{1}{A} \text{ x } 1000 \quad \text{…………………………………………………………...…(2)}$$

Notes:
A: Mudharabah Fund; B: Financing; C: Financing Income; D: Number of days in a month. Mudharabah and Financing, are expressed in average daily balances, while Financing Income is cash received from financing revenue in that month.

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Both GER and HI-1000 show the mudharabah investment yield before distribution between *shahibulmaal* (IAH) and *mudharib* (IB). At the second stage, based on the GER/HI-1000 value, IIB will calculate the share of profit attributed to each customer according to the amount of placement, tenor and profit-sharing ratio using the following formula:

Return for IAH (in Rupiah):

- Based on Gross Equivalent Rate (%. pa.):

$$\text{Amount x GER (\%. pa) x } \frac{Ratio}{100} \text{ x } \frac{Days\ of\ Placement}{365} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots..(3)$$

- Based on HI-1000 (‰) :

$$\frac{Amount}{1000} \text{ x HI-1000 x } \frac{Ratio}{100} \text{ x } \frac{Days\ of\ placement}{Number\ of\ days\ during\ distribution\ period} \quad \ldots\ldots\ldots\ldots\ldots\ldots.(4)$$

4. Of the 7 Islamic bank respondents, there was only 1 bank that did not apply income smoothing in its profit distribution. Meanwhile, of the other six, 3 banks implemented income smoothing with reserves, and the other three banks implemented without reserves.

Fulfillment of the Legal Maxim of *Al-Ghunmu Bi 'l-Ghurmi*

1. All IIBs implement revenue sharing in distributing mudharabah income. It means that there are no costs that are factored in the calculation of profit that will be shared.
2. The distributed income is only the one that originated from financing activities. IIBs do not share other operational income, such as foreign exchange transactions, buying and selling securities, payment services and other banking services' fees.

The Equality of Mudharabah Fund Value with the Asset Value

1. Because the distribution of profit is carried out in every end of month, in allocating income to be shared with IAH, IIBs calculate the value of financing (can be considered as mudharabah asset) and the value of mudharabah funds (deposit) based on its' daily average balance. The portion of mudharabah funds in financing will be used to calculate the proportion of income that will be shared.
2. Profit sharing which is calculated at the end of the month is considered final, and there are no further adjustments even if there are losses revealed at a later date.
3. Mudharabah funds are treated by IIBs as a deposit, not an investment. Mudharabah funds are recorded at historical value. Therefore, if there is a withdrawal, they will be paid back according to their nominal value (without prior revaluation based on mudharabah asset value).

PSIA as a Loss Absorber

Even though it is not stated explicitly, by implementing a revenue (gross income) sharing mechanism, IIBs treat PSIA as deposits whose principal is guaranteed. All the expenses as well as provisioning and write off of NPF, will be borne by IIBs.

Discussion

Use of Ratios in Profit Sharing

Use of ratio and calculation of returns

Although the use of ratios in mudharabah is a criterion that differentiates mudharabah from interest-bearing loans to incentify both parties working together, the research reveals that calculation of profit sharing is not free from the influence of time value of money concept (Shah and Siddiqui, 2018; Apriantoro and Mellinia, 2023; Mardiah, 2023). It is shown that the PSIA which will mature next month, then the amount of profit that will be paid to *shahibulmaal* will already be known by the time the bank has completed profit sharing calculation at the end of the previous month, because it will be calculated using the previous month's GER / HI-1000. It means that profit paid to the IAH is not fully

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generated from the use of fund within corresponding placement period, where all the profit is calculated merely based on GER/HI-1000 of previous month (although the revenue for entire period of placement has not been known).

The dynamics of changing parties, mudharabah capital which can change at any time, as well as profit/loss calculations which are carried out once in a month, make it difficult for IB to share profit with *shahibulmaal* whose a placement take place in the middle of month (Ayub and Ibrahim, 2013). The influence of the conventional mindset which views mudharabah funds as having characteristics like a debt and the concept of time value of money, have forced IB to pay returns for *shahibulmaal* according to previous month's Gross Equivalent Rate/HI-1000.

Actually, this step can be justified, provided the payment is considered as an advance payment, which will later be adjusted based on actual profit (AAOIFI, 2017b). However, this is not done by IIBs, due to inability to adjust the profit that has been paid to IAHs. All interviewees also acknowledged the lingering influence of conventional banking practices, where depositors receive fixed interest on their deposits. This mindset can lead to pressure to provide similar guaranteed returns in mudharabah partnerships.

Benchmarking

Because Islamic finance departs from prohibiting interest on lending and borrowing, there is debate among academics about how to measure the level of profit from an investment according to sharia (Billah, 2022). IB stakeholders are used to using conventional bank interest rates in determining its financial product price. This effect is visible in the way Islamic banks do business, as they frequently utilize interest rates as a benchmark for their operations.

However, the axiom which states that the Islamic financial sector should be closely linked to the real sector, encourages practitioners and academics to look for benchmarks that are in accordance with the characteristics of IBs. To the best of authors' knowledge, there have been no reports of success from these efforts. Taqi Usmani was among those who allowed benchmarking to conventional bank interest rates to be carried out by IBs in determining "the price" of a financial product (Jaman, 2011). In determining profit sharing ratio, IB envisages that under its current yield of financing, IAH will receive a rate of return, which is equivalent to deposit market interest rate, and then profit-sharing ratio will be calculated backward accordingly.

Profit Distribution Management (PDM)

The research revealed that the IIB's don't let profit sharing ratio play sole role ini distributing profit between the banks and IAHs. In fact, the banks perform PDM. PDM means that the bank does not share the income just the way it is, but to manage by one way or another, and hence IAH (collectively or individually) will receive yield of PSIA as targeted by the bank. Both reference guidelines allow IBs to practice it. In addition to avoid fluctuation of IAH's income, PDM aims to maintain product competitiveness by keeping IAH's income equal to deposit interest rate. This can be done with a reserve formation mechanism (PER), or in the case of IIBs, with grants (*tanazulul haqq*).

PDM is also referred as income smoothing. Many criticisms have been directed at the practice of income smoothing by Islamic banks (Lahrech et al., 2014; Alaeddin et al., 2017; Grais and Pellegrini, 2006). Management of income smoothing in Islamic banks can involve various factors such as competition, concentration, provisions for loan losses, and ownership structure (Khan et al. 2021). Although there is justification from *fiqh* point of view for this practice, income smoothing will indirectly form customer expectations.

Due to the concerns about withdrawal risks, IBs have the opportunity to abuse this practice. In DSN-MUI fatwa, this is anticipated by the clause in the fatwa which states that "*The Income Smoothing Method policy must not be implemented if it creates a tendency for hidden usury practices where profit for IAH is paid without regard to actual results,"* (DSN-MUI, 2012). Income smoothing in Islamic banks must be in line with sharia compliance, corporate governance practices, and profit-sharing ratios to ensure ethical practices and regulatory compliance (Khan et al., 2021).

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Fulfillment of the Legal Maxim of *Al-Ghunmu Bi ʻl-Ghurmi*

Neither AAOIFI nor the DSN-MUI Fatwa regulate the types of income and risks that IAH are entitled to or must bear. AAOIFI stipulates that profit sharing distribution is carried out using the profit sharing method, while the DSN-MUI fatwa, in addition to profit sharing, also allows IIBs to apply revenue sharing method. However, one of the legal maxims of every Islamic financial transaction reads *al-ghunmu bi ʻl-ghurmi* which govern that Islamic finance business should run based on risk sharing (Azrak and Hazaa, 2021). This legal maxim of course also applies to mudharabah contract (Sharif, 2013).

All IIBs currently use the revenue sharing method. Interviewees state that currently, all Islamic banks operating in Indonesia utilize the revenue sharing method as the primary mechanism for mudharabah. In addition, not taking into account costs in determining the profits to be distributed, IIBs also do not consider financing losses due to bad debts, either in the form of provisions or writing off losses as costs that reduce the income to be distributed. This raises the question on the relevance of risk sharing as the main characteristic of mudharabah. That mudharabah is stated to be a fairer system than interest-based lending and borrowing transactions, because IAH is entitled to a profit on the basis it is exposed to the risk of decreasing/losing the principal (Mughal, 2012).

By recording PSIA as part of on balance sheet item, the use of funds by IBs cannot be differentiated from one source to another (Grais and Pellegrini, 2006). On the other hand, even though it is not regulated or stated explicitly, Islamic banking stakeholders assume that PSIA fund is only intended to be channeled into financing, and therefore the income that will be shared with IAH is the one which generated from that financing only. By recording PSIA on the balance sheet, IAHs are also faced with other risks faced by banks, such as market risk and operational risk (Hamza and Saadaoui, 2013). Considering the above discussion, it can be concluded that the distribution of profit carried out by IIBs is not in conformity with the legal maxim of *al-ghunmu bi ʻl-ghurmi.*

The Equality of PSIA Value to the Asset Value

PSIA value in profit distribution

Due to IIBs are commingling mudharabah funds with other sources of fund, IIBs are required to allocate income that will be shared with the IAHs, from its total income. This is done by proportionally calculating the contribution of mudharabah funds in the financing portfolio. Because the profit distribution is carried out once a month, it is necessary to determine how to calculate the contribution of mudharabah funds in overall bank financing.

For this purpose, AAOIFI allows IBs to use the duration of placement from each source of funds as a weightage factor, which is known as the scoring method (currency unit x time unit). Meanwhile, DSN-MUI fatwa does not regulate this matter. However, this research reveals that IIBs use the average daily balance to calculate the portion of income that will be shared between the banks and IAH. Thus, in determining the value of mudharabah capital contributions, both the AAOIFI provisions and the practices carried out by IIBs, in addition to use historical cost method, it's also considered the duration of placement, regardless of the value of corresponding assets.

PSIA value at the time of withdrawal

AAOIFI set out that the capital value of mudharabah must take into account profits/losses that have not been shared as well as all reserves formed. However, to overcome the non-sharing of the entire potential income that will be generated, AAOIFI recommends that IBs and IAHs should agree on *mubara'ah* (release of commitment), for profits/losses that have not been shared. Meanwhile, IIBs pay PSIA withdrawals according to their historical value plus earned share of profit. The payment is considered final, regardless of the fair value of it's corresponding asset.

In contrast to this phenomenon, procedures derived from AAOIFI Sharia Standards requires that profit sharing payments at the end of the month should be treated as an interim profit that is not final. Finality of profit distribution is made through *tandeed,* either *haqiqy* (actual) or *hukmy* (constructive) mechanism. All payments made before the *tandeed* will be adjusted based on the *tandeed* result. If the *tandeed* is applied continuously, the PSIA value will always be reflected in the asset value. Meanwhile, DSN-MUI does not regulate anything on finality of profit sharing, including the implementation of *tandeed*. However, in one of the fatwas, it is stated that in managing mudharabah funds, *shahibulmaal* must be in the name of the mudharabah entity, not in their own name. Indirectly, it shows that, according to DSN-MUI, the PSIA value should always be the same as the mudharabah asset value.

PSIA as a Loss Absorber

Deposit with conventional banks is characterized by having principal guaranteed, but still could obtain returns. Bank deposits are considered suitable for most people who have a risk-averse profile. Therefore, IBs also try to meet the risk appetite of investors who have a risk averse profile, by one way or another to protect mudharabah principal funds (Hamza and Saadaoui, 2013).

Even though based on AAOFI guidelines PSIA acts as a loss absorber, in an effort to protect the principal from losses, AAOIFI allows the formation of a principal loss reserve, known as the Investment Risk Reserve (IRR). This reserve is set aside from the IAHs' share, which will be used if the bank's financing suffers a loss and subsequently will cause IAHs losses (Farook et al., 2012). Investment Risk Reserve (IRR) and Profit Equalization Reserve (PER) are important tools in Islamic banking to manage liquidity challenges and overcome risks effectively (Widarjono et al., 2023). However, the effectiveness of IRR in managing investment risk in Islamic banks may be hampered by regulatory structures that are not fully in line with sharia principles (Uddin, 2022).

IIBs do not apply principal protection using IRR. This is because IIBs apply revenue sharing method, and recognition of the mudharabah capital value is carried out according to historical values. These two things indirectly protect the IAHs' principal funds. This practice obviously contravenes the mudharabah principle set out by most of Islamic standard body. Nevertheless, this practice is affirmed by the issuance of DSN-MUI fatwa number 105/2016. Although the fatwa states that guarantees can only be given voluntarily by *mudharib* (in this case, Islamic banks), this practice will cause the problems accompanying the application of mudharabah contracts in fundraising as criticized by researchers and supporters of Islamic banks persist.

Interview with the Expert

In order to understand the reason behind the practices as found from the field study, interviews were conducted with some experts in the field of Islamic banking. The interview respondents consisted of: OJK officials (1 person), DSN (1 person), BI (1 person), academician (1 person), and practitioners (2 people). The results of the iterview can be summarized as follows:

1. That the implementation of the mudharabah contract is currently not running ideally. This is because the Government carries out a strategy to grow the industry first and then gradually strengthen the identity of Islamic banking, and the uniqueness of its products. In addition, it also considers the readiness of the community to accept the consequences of the ideal implementation of mudharabah.
2. It is necessary to propose an ideal model for the implementation of mudharabah contracts, so that Islamic banks can realize the ideals of Islamic economics. One of the important factors in the preparation of the model is the determination of costs that can be taken into account in the profit/loss of mudharabah cooperation. This is because in practice, there are investment expenditures for banks as *mudharib*. It was also emphasized that the determination of profit and loss in mudharabah cooperation must be carried out with a tandem mechanism.
3. The mudharabah contract is highly dependent on the level of trust of the parties. The development of the world of digital technology (including block chains), can be used to strengthen trust through the provision of accurate and real-time information.

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4. The development of an industry that is too much in pursuit of the target market can result in Islamic finance industry players making innovations that imitate conventional finance, so that it can threaten the credibility of Islamic banks.

Proposal for Improvement

There are several IB operational models proposed by some researchers to rectify the discrepancy of mudharabah implementation in fund mobilization. Among others are as follow:

1. Atmeh and Ramadan (2012). They proposed to segregate between assets financed by mudharabah fund from the other, but both are recorded on the same balance sheet.
2. Archer and Karim (2009). They propose mudharabah contract should be managed under separate entity.
3. Bacha and Mirakhor (2015). They proposed to identify asset financed by mudharabah fund. Idenfitication and separation also can be made by way of asset securitization.
4. El-Gamal (2006). Instead of asset segregation or tagging or securitization, he proposed mutual banking model, where shareholders and *shahibulmaal* will jointly own the asset of the bank.

Apart from being able to meet mudharabah basic feature, the operational model of IBs is also expected to maintain the characteristics of IBs as commercial banks those are able to increase economic liquidity through a fractional reserve system. For this reason, the authors propose an operational model for implementing mudharabah along with procedures for profit distribution, which is expected to fulfill these two objectives, which for simplicity is called: Quasi Equity model. The proposed model follows the line of mudharabah theory put forward by Toutounchian (2009). The proposed model can be viewed as a combination and/or modification of the Bacha-Mirakhor (2015) and El-Gamal (2006). Under the proposed model, several deviations over mudharabah implementation in PSIA are corrected and/or perfected, through some measures as explained in Table 3 below.

Table 3 Measures to rectify some deviations of mudharabah application

No.	Criteria	Remedial Measures
1.	Purity of ratio free from Time Value of Money element	➢ To treat mudharabah fund as an investment in the form of sukuk as a certificate of ownership. ➢ Profit and loss calculations follow generally accepted accounting principles, and profit distribution is carried out on daily basis.
2.	Fulfillment of the legal maxim of *al-ghunmu bi 'l-ghurmi*	Profit sharing is carried out for all types of bank business activities.
3.	*Tandeed* implementation	Daily profit sharing and the use of tradable sukuk can be seen as a constructive form of *tandeed*.
4.	Mudharabah funds as a loss absorber	To apply the rules set out below.
5.	Disclosure and customer interest protection	➢ To set up a Board of Observers to represent *shahibul maal* to oversee bank's operation without interfering management of the bank. ➢ To ensure that the bank has an adequate and robust IT system which can process the transactions as well as daily profit distribution.

Source: The authors, 2024.

Based on the above measures, The Quasi Equity model, in general, is proposed to have the following features:

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1. Mudharabah funds are equity in nature, so they are not a placement of funds but rather an investment, which is realized in the form of certificates (sukuk) which are sold at nominal value or negotiated price. Losses on the sale of certificates below it's NAV at primary issuance by the bank are borne by the bank.
2. Unlike shares in general, mudharabah investors do not have voting rights.
3. IAHs have no claim as creditors over the assets of the IB. However, shareholders and IAHs rank *pari passu* as residual claimants in regard to other than fixed assets of IB, provided fixed asset value is less then shareholders' equity.
4. Mudharabah investments can be made for specific period. Unlike debt, the maturity date of this investment does not mean that the *mudharib* is obliged to repay back the principal of the funds invested, but rather indicates when the mudharabah contract ends at the agreed profit-sharing ratio.
5. At maturity, *shahibulmaal* can liquidate his investment, by selling his PSIA certificate to the bank or other party at a negotiated price, or extend it by following new conditions (including new *nisbah*, if any).
6. Mudharabah fund management is carried out as a pool of funds, commingled with funds from other sources. However, mudharabah funds are only used for working capital (not for capital expenditure in the form of land/building and production facilities).
7. IAHs and the bank will share profit (before depreciation of fixed asset and provisioning for NPF) generated from all banking business, be it in the form of financing income (including income of financing funded by non-remunerated fund such as demand deposit) and fee-based income of banking services, based on pre-agreed ratio.
   Note: Depreciation should be borne by the bank as *mudharib*, while provisioning is borne by the bank and IAHs proportionately.
8. Revenue and expense are recognized based on generally accepted accounting principles (including accruals and amortization) and are used as the basis for daily profit distribution. Upon the completion of profit distribution, the bank liquidates its assets constructively to determine Net Asset Value (NAV) of mudharabah fund.
9. Losses as a result of a decrease in the principal value of financing are borne by the IAHs, and likewise the recovery does not become part of the shared income (Usmani, 1999).
10. The Net Asset Value of mudharabah funds is an indicative value used to assess participation of new placement and withdrawal of mudharabah funds.
11. Withdrawal of mudharabah funds/termination of participation is carried out by selling the investment to the bank or other party, at a negotiated price. If no other party purchase the investment, the bank will, under the best-efforts basis, facilitate the sale of mudharabah investment of IAH (or even sell their mudharabah assets) to other third parties (Siddiqi, 1983; Usmani, 1999).
12. To protect IAHs' interest, a Board of Observer can be formed and tasked to monitor how the bank conveys their fiduciary duty under mudharabah contract, without having the power to interfere the management of the bank.
13. To protect the interests of IAHs, profit distribution is carried out according to the rules as set out in Table 4 below.

Table 4 Rules for profit sharing

Scenario	Operating Profit exl. Depreciation	Provision for NPF	Operating Profit + Provision	Shared Item
1	Profit	Formation (-)	Positive	Net profit
2	Profit	Formation (-)	Negative	Not shared
3	Profit	Reverse (+)	Positive	Operating profit
4	Make a loss	Reverse (+)	Positive	Not shared
5	Make a loss	Formation (-)	Negative	Not shared
6	Make a loss	Reverse (+)	Negative	Not shared

Source: The authors, 2024.

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By implementing the model, IBs will have unique features and very different risk profile compared to its conventional counterpart at micro level. It will be better capitalized, and more relisient with regard to liquidity risk and interest rate risk. At macro level, IBs will move in line with the real sector and could be expected to be more resilient toward economic cycle.

CONCLUSION

From this research, it can be concluded that the implementation of the mudharabah contract in PSIA by IIBs does not meet the four basic criteria of the mudharabah contract. Mudharabah funds are still treated as debt, with rewards/return calculated using profit sharing ratio.

The research brings to the fore a possible contrast on how PSIA of Islamic Banks operate *vis-à-vis* the fundamental pillars of mudharabah contract. This is an important area where Islamic banks may be required to align their operations with sharia. The paper shall draw attention on this matter and call for discussion and reforms in the industry.

To rectify the deviations, this research proposes Quasi Equity Model. Having robust IT system is pre-requisite to implement the model. To increase IAHs protection and strengthen its trust toward bank, it could also be considered to establish a Board of Observer as a representative of IAHs, without the right to intervene decisions making process of bank management. Implementation of the model can be conducted in stages, starting with introducing it as a product, and set a target date for full implementation as IBs operating model.

There is a fundamental difference between this proposal and the proposal submitted by AAOIFI in the consultative meeting mentioned in the previous paragraph. In the Quasi Equity Model, mudharabah contracts play a role in converting money from potential capital to actual capital. Meanwhile, AAOIFI's proposal views mudharabah as just a business cooperation contract with profits to be shared, while still maintaining customer funds recorded in PSIA/UIA as money (potential capital) that must be maintained in its value.

It is worth noting that the implementation of the model requires paradigm shift for IB’s stake holders on the nature of IB business which is close to capital market as opposed to money market. IAHs are no longer acting as depositors but investors whose risk and return trade off similar to equity investors. Adapting the Quasi-Equity Model may require Indonesian regulators to alter regulation pertaining to either the capital adequacy ratio or calculation of profit-sharing for PSIA products.

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