

# Mudharabah Deposit Returns in Islamic Banking: Pre IFSA Evidence from Malaysia.

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## Abstract

Mudharabah is a concept of joint venture between the investor (Rabbul Maal) and the entrepreneur (Mudharib) that would not exactly be involved in the business and at the end of a stipulated period, the entrepreneur would return to the investor the principal and the proportion of profits made. Return to the depositor will be based on the Profit Sharing Ratio (PSR) and entrepreneur will be given return after deduction of Profit Earning Ratio (PER) and Internal rate of Return (IRR). This research analyzes the factor that contributes to the Rate of Return (ROR) given, whether it is influenced by Islamic Bank performance [Return on Asset (ROA), Return on Equity (ROE), Per Policy, Ownership or economic factors (GDP, UER). Data was collected from 16 Islamic banks in Malaysia from 2008-2013 (before IFSA 2013) The data was analyzed by using Stata software, and came out with Pool OLS, Panel OLS, Fixed Effect and Random Effect analysis that contributed to the finding of the study.

**Keyword:** Mudharabah, Mudharabah Deposits Return, ROE, ROA, GDP, UER, PER Policy.

## 1. Introduction

*Shariah* obligation is the key success factor of Islamic Banking in Malaysia. Therefore, any products and services offered by Islamic-banking system are in high demand by the customer. This then, directly contributed to the faster growth of Islamic Banking. People seek for Islamic Banking products and services because of religion obligation itself and people should understand the uniqueness of each product and services. [1,2]. This paper focuses on the *Mudharabah* concept in the Malaysian banking landscape. With the introduction of Islamic Finance and Services Act 2013 (IFSA 2013), *Mudharabah* was known as deposits account, and is now changed to 'investment account' and classified as an 'investment'. The gap between the literature papers is the reason of this current study. To be precise, this research paper intends to study the factors that influence the *Mudharabah* rate of return. The objectives of these study are: 1) To analyze the relationship between internal factor of Islamic Bank with *Mudharabah* Deposits return; and 2) To investigate the external factor relationship with *Mudharabah* Deposits Return in Islamic Bank. Then from this research finding, it will help the Islamic Bank to determine the return effectively and to minimize the misunderstanding of people regarding the return of *Mudharabah*.

## 2. Review of Literature

In the context of Islamic bank, some researchers highlights that the rate of return on deposits is based on the business performance

(profit) of the Islamic bank [3,4,5]. This is in contrast to the conventional banking practices in which the rate of return on deposits is based on conventional interest rates, which in turn is based on the pre-determined interest rates. However, the current practice of Islamic banks is such that the rates of return on deposits mimics that of the conventional bank's interest rates, hence this might lead to a violation of the *Shariah* principle [6]. Several scholars had explained about economic factor that influence the performance of the Islamic banks and at the end would affect the rate of return on investment. GDP is a monetary measurement of the market value of all final goods and services produced by one country. Hence, this represents the economic condition of one country. Economic factor can influence *Mudharabah* return [7]. Economic factor can be examined by numerous factors, and unemployment rate is one of it. Unemployment rate refer to the percentage of the population of one country that unemployed. Based on a study conducted by [8], unemployment rate would influenced the total *Mudharabah* deposit. [9] found that GDP and unemployment rate had significant effects on bank performance. Internal factor of the Islamic Banking will influence the performance of the Islamic Banking and at the end the fund performance. Return on Asset (ROA) and Return on Equity (ROE) indicators are used to measure the Islamic banks' performance. ROA have a significant relationship with return to *Mudharabah* as mentioned by [10]. IFSB (2010), explained Profit Equalization Reserve (PER) as comprised of amount appropriated out of gross income from *Mudharabah* for smoothing the returns paid to the investment account holders. Islamic bank made a tremendous fund under PER provision. After IFSA 2013, PER provision been eliminated since

collected amount under PER not being fully utilized by Islamic banks in Malaysia. The deduction of PER will affect the return available to the depositors [11].

### 3. Econometric Methodology

Data was collected from annual report of 16 Islamic banks in

$$MDR = \alpha + \beta_1 \text{Mudharabah Deposits} + \beta_2 \text{ROA} + \beta_3 \text{ROE} + \beta_4 \text{PER Policy} + \beta_5 \text{Ownership} + \beta_6 \text{GDP} + \beta_7 \text{UER} + \epsilon$$

**Table 1:** Correlation Matrix (all variables)

Variable	Mudharabah deposit	Return on Equity	Return on Asset	Gross Domestic Product	Unemployment Rate	Per Policy	Ownership
Mudharabah deposit (MDR)	1						
Return on Equity (ROE)	0.1224	1					
Return on Asset (ROA)	0.2575	0.7259	1				
Gross Domestic Product (GDP)	0.0873	-0.0367	0.0637	1			
Unemployment Rate (UER)	-0.0866	-0.1571	0.0818	0.0877	1		
Profit Equalization Reserve Policy (PER Policy)	0.0514	-0.0405	0.0928	0.0201	0.2986	1	
Ownership	0.069	0.0881	0.1565	0	0	0.1913	1

The correlation coefficient in Table 1, tested among all independence variable to check for the collinearity issues. All 66 observations have been tested. Result shows that for each variable the correlation coefficient value is less than 0.800, suggesting that the absence of multicollinearity problem.

Based on the research objective were determined the relationships between *Mudharabah* deposits return and the ROA, ROE, PER Policy, Ownership, GDP and UER. Table 4, provides the results obtained from Pool OLS, Panel OLS Models, Fixed Effect and Random Effect. Two tests have been conducted to analyze it. By conducting **Breusch and Pagan Lagrangian** multiplier test, result shows Prob>chibar = 1.00, thus means rejecting the null hypothesis of the homogeneity data and Panel OLS is used. Based on **Hausman Test** result the Prob>chibar 0.9858. Therefore, the null hypothesis cannot be rejected. Random Effect model is more appropriate to this research. The R squared is 0.918 and adjusted R squared 0.9081, indicates that the model of equation is fit. While the balance 9% of the variance remain unexplained by the selected variables. The result from Panel OLS shows that GDP, UER and PER Policy are less than 0.005 significant values that indicate there are significant relationship effects towards *Mudharabah* Deposits Return. Also it can be seen from the coefficient number (---3.743559, ---89.6788, 0.05963). This revealed that GDP has negative relationship towards *Mudharabah* deposits return, which means an increase of one unit in GDP will decrease the *Mudharabah* deposit return by ---3.743559 when the other variables are consistent. It indicates and explained the same thing to UER and PER Policy. Result from Random Effect analysis shown the significant value of ROE, GDP, UER, PER Policy and Ownership is less than 0.05 indicate that the variables has a significant effect towards *Mudharabah* deposits return. It also can be seen from the coefficient number. This revealed that ROE (-0.04754) has negative relationship towards *Mudharabah* deposits return, which means an increase of one unit of ROE will decrease the *Mudharabah* deposits return by -0.04754 when the others variable is consistent. It indicates and explained the same thing

to GDP, UER, PER policy and ownership. For the two analyses the significant factor is similar compared to ownership and ROE. The both economic factor (GDP and UER) are significant in all 4 methods of analysis. Therefore, it shows that economic factor influence *Mudharabah* rate of return. [12], support this. GDP commonly used as economic performance determinant for the whole country. Economic condition influenced the rate of return

Malaysia. These 16 Islamic banks consist of both local and foreign banks; full fledge Islamic banks and Islamic window from the year 2008-2013. However, due to the unavailability of PER data, only 11 Islamic Bank in Malaysia were selected. Stata Software was used to analyze the data. Statistical testing such as OLS, Pools, Panel, Fixed Effect and Random Effect analysis were applied in the study in order to test the hypotheses developed for the research. The prediction equation is:

for any investment. This is relating with investment theory. This finding totally shows that Islamic Banking will take the economic condition in calculating the return to the depositors. Unemployment rate also influence the rate of return too since unemployment rate is high it will influence the total *mudharabah* deposits and at the end, will give impact on the return [13]. For Islamic Bank, factor of PER policy is significant for all test, it shows that Islamic Bank that have Profit Equalization Reserve Policy (PER) can influence the return offered to the depositors. As mention before PER is actually act as a cushion to the bank in case of the market downturn or the fund is not profitable. ROE and ownership of the bank, is significant only for random effect analysis. For the conclusion, *Mudharabah* Deposit Return more influence by the external economic factor that is GDP and UER. Islamic bank should have certain risk management to deal with these two factors, to make sure that the return offered is attractive.

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**Table2:** Panel Regression Model

Mudharabah Deposits Return	POOL OLS (P>Z)	PANEL OLS (P>Z)	FIXED EFFECT (P>Z)	RANDOM EFFECT (P>Z)
Mudharabah Deposit	0.006596 (0.974)	0.006596 (0.974)	0.35963 (0.404)	0.28233 (0.260)
ROE	0.006307 (0.952)	0.006307 (0.952)	-0.04411 (0.103)	-0.04754 (0.037**)
ROA	0.0133159 (0.335)	0.0133159 (0.331)	0.003947 (0.234)	0.00322 (0.254)
GDP	-3.743559 (0.000**)	-3.743559 (0.000**)	-3.65033 (0.000**)	-3.64309 (0.000**)
UER	-89.6788 (0.000**)	-89.6788 (0.000**)	-94.8541 (0.000**)	-93.6986 (0.000**)
PER POLICY	0.05963 (0.008**)	0.05963 (0.006**)	0.07819 (0.004**)	0.06707 (0.002**)
OWNERSHIP	-0.01424 (0.435)	-0.01424 (0.432)	Omitted	5.9673 (0.000**)
_CONS	0.000	0.000	0.000	0.000
R SQUARED	0.918			
ADJUSTED R SQUARED	0.9081			
BREUSCH PAGAN ANALYSIS	Prob> Chibar2 = 1.00			
HAUSMEN TEST	Prob >chi2=0.9858			