Comments of

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on

The Analysis on the Feasibility Study of *Mushārakah Mutanāqisah* Implementation in Indonesian Islamic Banks

by

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Basically, the paper reviews the pricing of three different types of financing i.e. *muḍārabah, mushārakah mutanāqisah* and flat rate interest payment. These three methods of payments would result in different confident levels particularly when facing uncertainties in the financial environment i.e. Interest rate. The more expensive the products are offered, less acceptable the products to the market. Therefore, the pricing is one of most important aspects besides, of course, the Sharīʿah compliance; since it reflects the level of the operational efficiency of the industry.

Practically, the public acceptance over the Islamic financial products would depend upon two major things: Sharīʿah compliance and pricing as they would affect their satisfaction. This applies to the both side: asset side as well as liabilities side. These two types of satisfactions are traded off particularly when they are contradictory one to another. A customer would seek the optimal level wherever it is available. The optimality would meet when the marginal cost is the same as its marginal benefit. This means that a Sharīʿah minded customer would choose the Sharīʿah products when the marginal excessive cost is at the same level as the marginal benefit taken from the choice to Sharīʿah compliant products.

When we talk about the level of acceptance of Sharīʿah banking products, we should start our discussion from how the financial structure of an Islamic bank is built. This would require us to understand the preference of the investors when they put their funds with the Islamic banks. Ideally, the investors/depositors of the Islamic banks could only expect the returns based on the real performance of the bank ex-post. However, there is a strong possibility, particularly when the Islamic banking system is the market follower, that the market preference would be driven by the interest rate. In this case, the cost of capital of the Islamic bank would also be affected by the interest rate movements. If this condition applies, the investment managers of the Islamic banks should always adjust the pricing of the products so

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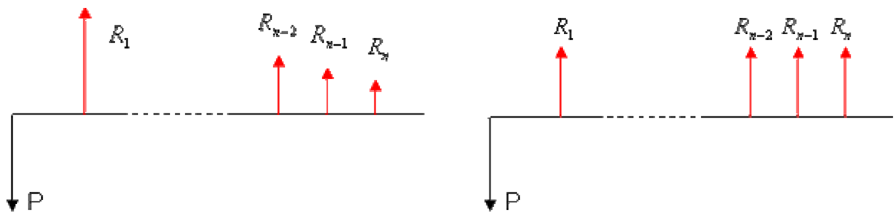
that the Islamic bank could always entertain the investors well. In an Indonesian case, the Islamic banking has just reached its infancy stage, whilst the Sharīʿah minded customer base would only built through sufficient customer education and time. One could predict that the market preference would be significantly affected by the interest rate as benchmark of the return.

The Islamic non-PLS products are usually built on the flat payment basis. The investment managers should be able to synchronize the level of return to the cost of capital; otherwise, the bank would suffer from financial losses since the cost of funds follows the market rate. The assets and liabilities committee of the bank should have sufficient information when predicting the future condition of the market which is reflected as risk premium.

If we compare the three schemes of financings, we would have basically two basic financings. We have the *murābaḥah* and flat payment financing at one hand and *mushārakah mutanāqisah* at the other hand since *murābaḥah* and flat payment scheme generally have the same cash flow profile as illustrated in the following **Exhibit 1(a) and 1(b)**.

Exhibit 1

Cash flow profile

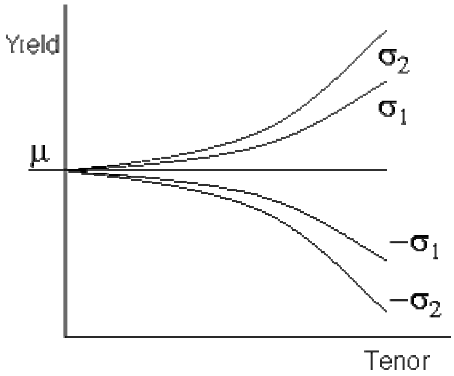


1(a) Mushārakah *mutanāqisah* **1(b) *Murābaḥah***

As mentioned earlier, both financing types are exposed to the interest rate movements. Given a is the correlation index of the Islamic bank depositor, the level of risk exposure toward interest rate is a function of interest rate volatility and the correlation level.

Exhibit 2

Yield curve

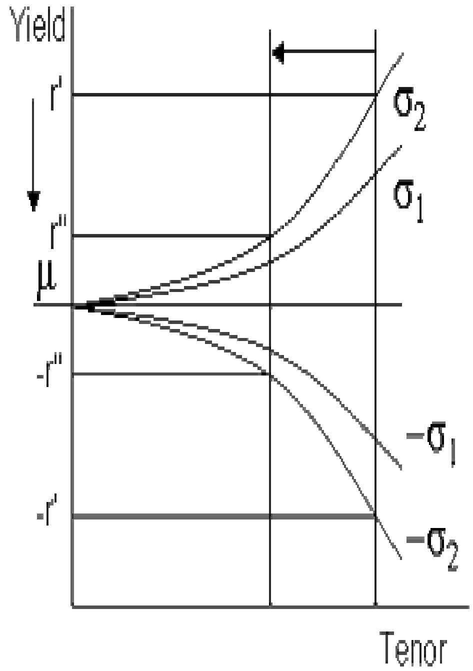


If the depositor preference is perfectly correlated on the liabilities side, the bank will be more exposed to the interest rate risk as it is in the conventional bank. The risk would depend upon the volatility of the interest rate. **Exhibit 2** illustrates different yield curves as a result of different market volatility where $\sigma_2 > \sigma_1$. If the preference of the depositors is not correlated to the interest rate movements, the bank would be exposed to the lower interest rate risk.

Referring back to the cash flow profile, the basic difference of the *mushārakah mutanāqisah* as compared to the *murābaḥah* financing, lies upon the proportion of the income to the bank which is accrued in a more advance. This type of financing would be considered more superior to the *murābaḥah* contract since a larger portion of is not anymore exposed to the interest rate movements. This means that the weighted-average of the income is shift to the shorter tenor as illustrated in **Exhibit 3**.

Exhibit 3

The comparison of the yield curve



Concluding my comments on the paper, firstly, I would personally believe that the applicability of fixed payment types of financing would depends upon how the cost of capital of the Islamic bank is constructed besides, of course, the ability of the investment managers when calculating the risk premium against the interest rate movements. Secondly, given the type of *mushārakah mutanāqisah* is another type of fixed payment scheme, it could deliver a lower risk exposure.