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Assesing Agency Theory and Solutions on The Financing of Revenue Sharing Systems in Islamic Banking

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Abstract

The dynamics of business development in Indonesia from time to time are increasingly complex. When in the past businesses were run by individuals or several parties and with a simple structure, but today has developed far in complex business entities, structured management and larger capital. One of the basic assumptions in accounting, the economic entity, states that a company is an independent economic entity that requires separation between the owner (owner) and the party running the business (management). Or common with the mention of agents and principals. The method used in this research is library research with qualitative descriptive analysis, information is taken from a number of references. The conclusion in this study is that the theory of agency ideally presents as a bridge of communication between agents and principals, but in practice problems and conflicts often arise. What happens, on one side the agent knows more about business information than the principal, for that if it does not have an honest sense of customer / agent can act moral hazard. Solutions in the agency's problems can be minimized by monitoring, bonding, and screening measures.
Keywords: *agency theory; Islamic banking financing; revenue sharing*

A. Introduction

The dynamics of business development in Indonesia from time to time are increasingly complex. When in the past businesses were run by individuals or several parties and with a simple structure, but today has developed far in complex business entities, structured management and larger capital. One of the basic assumptions in accounting, the economic entity, states that a company is an independent economic entity that requires separation between the owner (owner) and the party running the business (management).

Agency theory explains that in a company there are two parties who interact with each other. These parties are the owners of the company (shareholders) and managers of the company. Shareholders are referred to as principals, whereas managers, i.e. people authorized by shareholders to run the company, are called agents. But on the one hand, agents are proven to have more information (full information) than the principal, giving rise to information asymetry.

More information possessed by the manager can trigger to perform actions in accordance with the desire and interests to maximize his utility. As for the owner of capital in this case investors, it will be difficult to effectively control the actions taken by management because they have little information. Therefore, sometimes certain policies carried out by the management of the company are unknown or without the knowledge of the owner of the capital or investors.

Agency theory is important, especially for interested parties both agents and stakeholders who are bound in a contract. Therefore, this study focuses on problems arising from agency theory in an Islamic perspective as well as solutions to minimize agency problems in the financing of revenue sharing systems.

B. Research Methods

In this study, the authors used a qualitative descriptive approach to find out the extent and how to measure *agency theory* and its solutions on revenue sharing financing in Islamic banking. This study is focused on library analysis through books, web, papers, journals, web literature, both primary data, secondary and tertiary data. Related data that has been obtained is then processed in order to find the concept of measuring *agency theory* and its solutions on revenue sharing financing in Islamic banking.

C. Literature Studies

1. Definition of *Agency Theory*

The issue *of corporate governance* has long been known in European and American countries with the concept of separation between ownership and control of companies (Arifin, tt). This separation will cause problems due to differences in interests between shareholders (as principals) and the best interests of the principal. Jensen and Meckling (1976) in *agency theory*, define agency relations as a *nexus of contracts* in which one or more principals use other people or agents to carry out company activities. The principal is the shareholder / owner / investor, while the agent is the manager or management who manages the company. The principal provides facilities and funds for the company's operating needs, while the agent is obliged to manage the company

with the aim of increasing the prosperity of the owner or the company's profit (Anggraeni, 2011).

Rahmawati, et al explained that *agency theory* implies the existence of asymmetric information between managers as agents and owners (in this case shareholders) as principals. It is also affirmed by Pratamasari (2003) that in agency relations, managers have asymmetric information on external parties of the company, such as creditors and investors (Rahmawati, 2006).

2. Conflict Agency Theory (Information Asymmetry)

Agency conflicts occur because of the principal's interest in obtaining growing profits while agents are interested in receiving growing satisfaction in the form of financial compensation so that agents often take decisions not in the best interests of the principal, especially if *opportunistic* people are involved in it (Elfianto, tt). Kelly explained that the problems arising from this agency relationship actually stem from the management's desire not to act in the best interests of the principal (Rahmawati, 2006).

According to Fama and Jensen, in the absence of effective supervisory procedures, management is likely to commit irregularities that harm shareholders. For example, by showing some company conditions as if the target was achieved. So that shareholders feel that management is doing well and making a profit. However, due to the absence of effective supervision from shareholders, management constantly gives false statements to shareholders that can eventually arise problems in the company such as financial distress (Fama & Jensen, 1983, pp. 327-349).

Jensen and Mecking outlined the conflict between the principal and the agent mentioned that the agency's costs are the result of summation, in the form of:

a. Expenditure on *monitoring by* principal
b. Expenses on the existence of contractual agreements with agents, and
c. Other costs related to controlling the company (Najmudin, 2011, p.307).

One of the obstacles that arise between agents and principals is the asymmetry of information. Information asymmetry is a situation in which an agent has more information about the company and its future prospects than the principal. This condition provides an opportunity for the agent to use information he knows to manipulate financial reporting as an effort to maximize its prosperity. This information asymmetry results in the occurrence of moral hazard in the form of management efforts to do earnings management (Rahmawati, 2006).

According to Scott (2000), there are two types of information asymmetry, namely (Amaliah, 2016):

a. Adverse selection is that managers and other insiders usually know more about the state and prospects of the company than outsiders. And there may be facts that are not presented to the principal.
b. Moral hazard, namely that the activities carried out by a manager are not entirely known by investors (shareholders, creditors), so that managers can take actions beyond the knowledge of shareholders who violate the contract and actually ethically or normally may not be feasible.

3. Implementation of Ideal Agency Theory

The relationship between principal and agent is said to be successful if *the agency cost* is minimal, there is a balance in maximizing utility between agent and principal. This ideal condition is very difficult to achieve because the one that plays a role in the processing and access of information is an agent so that it causes asymmetric information, where the agent knows more than the principal.

Since the unit of analysis in *agency theory* is the contract that underpins the relationship between the principal and the agent, the focus of this theory is on determining the most efficient contract underlying the relationship between the principal and the agent. To motivate the agent, the principal designs a contract in order to accommodate the interests of the parties involved in the agency contract. An efficient contract is a contract that meets two factors, namely (Anggraeni, 2011):

a. Agents and pinsipals have symmetrical information meaning that both the agent and the principal have the same quality and amount of information so that there is no hidden information that can be used for his own benefit.
b. The risk that the agent carries related to his return is small which means the agent has high certainty about the rewards he receives.

4. Agency Theory in an Islamic Perspective

As already explained, agency theory is based on the relationship between principals and agents. The form of relation that underlies the existence of the relationship arises from the basic concept of trust. Triyuwono explained that trust is something that is entrusted to others to be used according to their wishes. which is mandating. This means that the party who gets the trust does not have an absolute ownership obligation for what is mandated. He has an obligation to

maintain the trust properly and utilize it in accordance with what is desired by the truster (Triyuwono, 1997).

Normatively, Muslim communities in peace generally practice accounting based on the command of Allah, as stated in QS Al-Baqarah: 282.

"O believers, if you say not in cash for the appointed time, let you write it down and let a writer among you write it correctly"

This order is actually universal in the sense that the practice of recording must be carried out correctly on transactions made by one person with another person. The substance of this order is: (1) the practice of recording that must be done with (2) true (fair and honest) (Anggraeni, 2011).

The correlation between the principal and the agent is a contractual relationship, so in it there is an element of transaction behind it. Islam clearly regulates how the principles of transactions are in accordance with sharia. Morals are norms and ethics that contain moral values in the interaction of fellow beings so that the relationship becomes mutually beneficial, synergistic, and harmonious (Wiroso, 2011, p.27).

The transactions carried out by Shariah entities are based on the principle of paradigm as follows:

a. Brotherhood *(ukhuwah)*

The principle of brotherhood (ukhuwah) is essentially a universal value that organizes social interaction and harmonization of the interests of the parties for general benefit with the spirit of mutual help. Sharia transactions uphold the value of togetherness in obtaining benefits (*sharing economics*) so that one should not benefit above the losses of others. Ukhuwah in Sharia transactions based on the principle of knowing each other (*ta'aruf*), understanding each other (*tafahum*), helping each other (*ta'awun*), mutual assurance (*takaful*), synergizing and allied (*tahaluf*) (Wiroso, 2011, p.27).

b. Justice *('is)*

The principle of fairness essentially puts something only in its place and gives something only to the rightful and treats something according to its position. Implementation of justice in business activities in the form of muamalah principal rules that prohibit the existence of elements:

1) Riba (flower element in all its forms and types, both riba *nasiah* and *fadhl*),

The essence of riba is any addition to the principal receivables required in the loan-and-borrowed transaction and its derivations and other non-cash transactions, and any additions required in exchange transactions between *ribawi* goods including the

exchange of money (*money exchange*) which is similar in cash and resilient and which is not the same in cash (Wiroso, 2011, p.27).

2) Tyranny (an element that harms oneself, others, and the environment),
   The essence of tyranny (*dzulm*) is to put something out of place, give something out of place, give something not according to its size, quality and tempo, take something that is not right and treat something out of position. Tyranny can cause harm to society as a whole, not just in part; or bring harm to one of the parties or parties who make the transaction (Wiroso, 2011, pp.27-28).
3) *Maysir* (element of gambling and speculative attitude),
4) *Gharar* (element of obscurity), and
5) Haram (illegal elements in both goods and services and related operational activities) (Wiroso, 2011, pp.27-28).

The essence of haram is any element that is strictly forbidden in the Qur'an and As-sunnah.

a. Benefit *(maslahah)*

The principle of benefit *(maslahah)* is essentially all forms of goodness and benefits of worldly and ukhrawi dimensions, material and spiritual, and individual and collective. Recognized benefits must meet two elements, namely sharia compliance (*halal*) and useful and bring good (*thayib*) in all aspects as a whole that do not cause harm (Wiroso, 2011, p.27).

Sharia transactions that are considered to be beneficial must meet in total the elements that are the purpose of sharia provisions (*maqasid syariah*) in the form of maintenance of: (a) creed, faith and piety (*dien*), (b) intellect (*'aql*), (c) descendants (*nasl*), (d) soul and safety (*nafs*), and (e) property (*mall*).

b. Balance (*tawazun)*

The principles of balance of its essence include the balance of material and spiritual aspects, private and public aspects, the financial sector and the real sector, business and social, and the balance of aspects of utilization and preservation. Shariah transactions do not only emphasize on maximization of company profits solely for the benefit of the owner (*shareholder*). So that the benefits obtained are not only focused on shareholders, but on all parties who can feel the benefits of economic activity (Wiroso, 2011, p.28).

c. Universalism *(syumuliyah)*

The principle of universalism can essentially be carried out by, with, and for all interested parties (*stakeholders*) without distinguishing tribes, religions, races and groups, in accordance with the spirit of universal mercy

(*rahmatan lil alamin*). Sharia transactions are tied to ethical values including the activities of the financial sector and the real sector that are carried out coherently without dichotomy so that the existence and value of money is a reflection of investment and trade activities (Wiroso, 2011, pp.27-28).

D. Agency Problems on Revenue Sharing Financing at Islamic Banks

It should be underlined that in the financing system, the correlation between Islamic banks and customers as in the relationship of two parties in agency theory, customers are as agents and Islamic banks as principals. Islamic banks own capital while customers are managers *(agents).* The relationship between the agent (*mudharib*) and the principal (Islamic bank) is usually in an asymmetric information situation. This can happen because there are parties who have more information (agent / *mudharib*) compared to other parties (principals / Islamic banks). Agents (*mudharib*) have more information because they are directly related to the company.

Asymetric Information or information inequality is a situation in which managers have different (better) information about the condition or prospects of a company than investors have. And Asymmetric Information arises as a result of the distribution of information that is not the same, in this case between capital owners. (*prinsipal*)/*shahibul mal* and capital manager (*agent*)/*mudharib*. Ideally, *the principal* obtains the information needed in measuring the level of results obtained from the agent's efforts. But in fact, the measures of success consumed by the principal cannot explain the relationship between the successes that have been achieved, and the efforts that have been made by *the agent*.

As already mentioned, that the potential asymmetry of information in agency problems is influenced by moral hazard and adverse selection (Richardson, 1998). Agency problems in Islamic banks generally arise in financing mechanisms, especially profit-sharing systems (Profit and Loss Sharing) where the value of risk that arises is also quite large compared to other financing such as buying and selling, looting, and others. The financing scheme with this PLS system is a *musyarakah* and *mudharabah contract.*

The emergence of agency problems between agents and principals in *the mudharabah* and *musyarakah* contracts is due to the existence of:

1. The misalignment of interests between Islamic banks as principals and *mudharib* as agents.

   As we know that in the mudharabah contract, the owner of the fund does not participate directly in business management, therefore from this *mudharib* far knows information on how the development of his business so that it can bring up information asymmetry and *moral hazard* actions can also occur.

One of the *moral hazards* that are often done on *mudharabah* financing is from the *mudharib* (capital manager) where the *mudharib* party is not honest in providing information to the owner of the capital (*shahibul mall*) related to the business that will be carried out in the future, and the *mudharib* party can deliberately use the capital in a way that is not appropriate. So that the capital management (*shahibul mall*) cannot know the extent to which capital is used, and capital managers are reluctant to provide guarantees because they cannot measure with certainty the risk of losses made by *mudharib.* Saadallah, said that *the moral hazard* caused by customers makes one of the reasons that underlie the lack *of mudharabah* financing applications at Islamic banks (Saadallah, 1999).

2. Unbalanced Division of Ratios and Risks

Both mudharabah and musyarakah contracts have their own characteristics in determining the ratio of profit sharing and risks that may arise in the financing process. In the mudharabah contract, the ratio is divided according to the agreement in the contract. But often less satisfied with what has been obtained, therefore the act of moral hazard to be dishonest between the principal and agent also appears. Then on the other hand also risk sharing. When the principal has provided funds for financing, there is a risk that the funds are not used as agreed in the contract. In the musyarakah contract, the emergence of *moral hazard* acts on information asymmetry also occurs. On the other hand, agents want to get maximum profitability so that they may take a policy outside the initial agreement contract.

Some of the following evidence shows problems in the implementation of *mudharabah* financing products, including (Friyanto, 2013, pp. 113-122):

a. The seriousness of *mudharib* customers in running a bank-financed business. In reality, *mudharib* companies do not always meet the expectations of banks. Often the obligations on financing to banks are not fulfilled properly, the development of the company falters and there is even the possibility of becoming bad financing.
b. Violation of the terms that have been agreed according to the agreement, so that in running a business financed by the bank is no longer in accordance with the agreement. There are concerns from banks about misuse of the use of funds (*side streaming*) where customers do not use their funds in accordance with what is stated in the agreement or contract, however, banks are unlikely to supervise continuously.

c. Internal management of *mudharib* companies that have not been carried out professionally according to the management standards agreed between banks and customers.
d. *Mudharib negligence* in running a bank-financed business.
e. Islamic bank as the owner of capital (*shahibul maal*) is still not convinced by the honesty of customers in reporting their business results. In some cases, there are still customers (*mudharib*) who are not trusted (*moral hazard*).

According to Antonio, the risks of *mudharabah* financing are caused by:

a. Asymetric Information problem, which is the tendency of one party who controls more information to be dishonest. Therefore, the determination of revenue sharing financing must be done by paying attention to incentive compatible constraints. (Limits to provide incentives for customers to be honest),
b. Side streaming is that the customer uses the funds not as mentioned in the contract,
c. Negligence and deliberate error (Antonio, 2001, p.92).

   Some other factors that affect *character risk* include:

   1) Negligence of customers in running a business that is charged by the bank,
   2) Violation of the agreed terms and
   3) Internal management of the company that is not carried out professionally according to the management standards agreed between the bank and the customer (Friyanto, 2013, pp.113-122).

E. Solutions to Overcome Agency Problems in Mudharabah Financing

The beginning of the emergence of agency problems as already mentioned is because of the out-of-sync interest between the principal and the agent so that information asymmetry arises between the two. Masalah which is very important is that Islamic banks have not fully believed in *mudharib* in the management of the funds it distributes.

For this reason, a number of offers of solutions to overcome agency problems, especially in financing in Islamic banks, are through:

1. Monitoring

   Given that financing issued by banks carries risks, then in all activities related to financing must be based on principles and policies. pembiayaan yang sehat, menguntungkan, konsisten, dan berkesinambungan.

   The purpose of monitoring in general according to Rickwood and Murinde in Muhammad (2005) is as follows: (a) to ensure the efficiency of allocation,

(b) to ensure the fulfillment of time limits, (c) to ensure the validity of information, (d) to maximize the efforts of agents, and (e) to obtain signs of information and (f) to uncover risks. The implementation of monitoring actions can be carried out in the following areas; (a) monitoring of production, (b) financial performance, (c) limits on profitability (profitability), (d) agent ability or prowess, (e) investments and (f) personal agent profits (Friyanto, 2013, pp.113-122).

2. Bonding

   In addition to implementing a monitoring system, managers themselves also need to make their own restrictions on their actions (bonding).

   The implication of these two activities is that (1) it can reduce the chance of manager deviations so that the value of the company (project) increases, while (2) both will bring up costs so that it will have an impact on reducing the value of the company (project) (Muhammad, 2008, p.68). Jensen and Meckling (1976) stated that potential investors will reduce the appearance of both costs coupled with losses that still appear, despite the monitoring and bonding, called residual loss (Muhamad, 2014).

3. Financing screening mechanism (*mudharabah / muyarakah*) as a form of prudential banking.

   In the mechanism of mudharabah contracts and agencies there are differences. Khalil mentions that:

   > *"In an agency theoritical framework, however, the ideal risk and profit – sharing contract relates to two parties who have identical probability beliefs with respect to the state of nature. One party is the insider (active) who is identified as the agent (entrepreneur); this party has knowledge about a risky profitable investment project which they wish to undertake, but they have zero initial funds to finance it. The outsider (passive) party is interpreted as the prinsipal (bank), who provides the full initial funds needed to establish the project* (Khalil, Rickwood dan Muride, 2000).

There are 3 main problems in the *mudharabah* contract, namely:

a. Idiosynchratic uncertainty (risk),
b. Extreme linearity,
c. Discretionary power.

Empirically, the results of the author's research found the following: (1) Practical considerations of Shari'ah Bank actors on projects to be financed with mudharabah contracts are that the project has: (a) the level of project health, (b) guarantee of payment agreements, (c) good prospects, (d) project financial statements, (e) clarity of contract validity, (f) firmness of contract time; (2) Practical considerations of Shari'ah Bank actors for *mudharib* to be financed by mudharabah

contracts, are that *mudharib* has: (a) business capabilities, (b) guarantees, (c) *mudharib* reputation, (d) the origin of *mudharib*, and (e) business commitments; (3) Project health attributes, project prospects, project financial statements, contract terms and contract time are project attributes considered by shari'ah bank actors financed with mudharabah financing that can effectively minimize the emergence of agency problems. (4) Attributes of business capabilities, guarantees, *mudharib* reputation, origin of *mudharib*, business commitment are attributes of the project is considered by shari'ah bank actors who can be financed with mudharabah financing which can effectively minimize the emergence of agency problems. (5) The mechanism for selecting project attributes and *mudharib* attributes [(a) the ability of *mudharib* business, (b) *mudharib* reputation, (c) business commitment, (d) project financial statements, and (e) contract time] can reduce the incidence of agency problems in mudhara*bah* contracts in Bank Shari'ah.

F. Conclusion

Agency theory is ideally present as a bridge of communication between agents and principals, but in practical terms problems and conflicts often arise. Agency problems in Islamic bank financing arise because among agents and principals are not aligned in having interests. On the one hand, agents know more about business information than principals, for that if you do not have a sense of honesty, the customer / agent can do *moral hazard*. Here are a number of solutions to reduce agency problems in mudharabah financing, including: 1) Monitoring; 2) Bonding; 3) Financing screening mechanism (mudharabah / muyarakah) as a form of prudential banking.

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