

Profit and Loss Sharing (PLS) as Basis Characteristic of Islamic Banking: An Analysis of Mudhārabah Contract

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Abstract

Mudhārabah constitutes one of the products in Islamic banking. It is a cooperation contract between two parties, where one party (rabbul māl) provides 100% fund and other (mudhārib) provide work. Profit will be shared between two parties according to a pre-determined profit sharing ratio contract known as nisbah. In the case of loss, the capital owner shall bear the monetary loss and manager or entrepreneur shall loose the reward of his effort unless caused by negligence or violation by mudhārib. This is core concept of mudhārabah, which gives fair business cooperation between two parties. This study will explore basis characteristics of mudhārabah in Islamic banking. The findings are that Islamic banking has certain basic characteristics from PLS such as as just system, as tool of efficient allocation of capital, as productive contract that support who have business either micro, middle or macro level, and as medium to reach the objective of Islamic economics.

Keywords: Profit; Loss; Sharing; Mudhārabah; Islam; Bank

Introduction

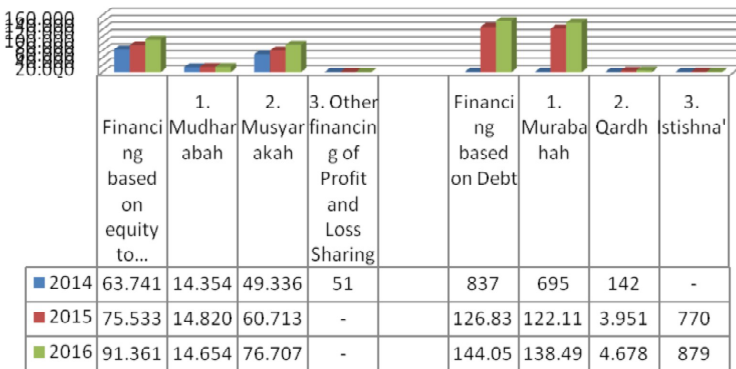
Islamic or Shari'ah bank (term used in Indonesia) constitutes as financial institution that functions to channel economic activities in real sector through trade, investment, etc., based on Shari'ah. Islamic bank has certain values that can be divided into two categories, namely macro and micro values. For instances,

macro values can be realized through justice, welfare and *maclahah*, while micro such as *siddiq*, *amânah*, *tabligh* and *fathonah*. Moreover, its objectives are successful in here (short term oriented) and the hereafter (long term oriented) known as *falah* that concerns with sources, process and benefit.¹

The first development of Islamic banking in Indonesia or South East Asia Countries (ASEAN) is known as bank of profit and loss sharing. This is distinction between Islamic and Conventional banking that uses interest as its instrument. But, Islamic banking does not operate with profit and loss sharing, but also trade, and other services such as *wakalah* (agency) and *kafalah* (guarantee). On the other hands, products offered by Islamic banking are based on equity, debt and fee. By several instruments offered by Islamic banking can be implemented flexibility in accordance with needs and specific situation that happened in practice.²

In practice, the use of products has been focusing on debt and fee based rather than equity based such as *mudhârabah* and *musyâarakah*. The comparison of financing is between 30 - 50 % as shown in figure 1.

Financing Based On Equity and Debt



Source: Statistics of Shari’ah Banking 2017, OJK

Figure 1: Financing Based on Equity and Debt

¹Ascarya, *Akad dan Produk Bank* (Jakarta: Rajawali Press, 2013), 30.

²Adiwarman Azwar Karim, *Bank Islam: Analisis Fiqih dan Keuangan* (Jakarta: IIIT Indonesia, 2003), 180.

There several reasons can be given for the popularity of *murābahah* in Islamic banking investment operations, they are: 1) *murābahah* is a short-term investment mechanism and is convenient compared with profit and loss sharing (PLS); 2) mark-up in *murābahah* can be fixed in a manner which ensures that the banks are able to earn a return comparable to that of interest-based banks with which the Islamic banks are in competition; 3) *murābahah* avoids the uncertainty attached to earnings of businesses under a system of PLS (Ahmad, 1985: 24)³ By then the use of *murābahah* thus declined sharply, its importance remaining in theory rather than in practice. Because PLS is risky product rather than others. In fact, no one claim any profit without incurring risk in business known is Islamic legal maxim *al-ghoum bil al-ghourm*.

Originally, the emergence of Islamic bank is to replace the bank with interest-based financing by bank that provides its extensive financial resources to the borrowers on a risk sharing basis. Therefore, as mentioned in early explanation Islamic banking was famous with the bank with PLS, but it has changed from Profit and Loss Sharing to Profit Sharing.⁴

PLS as core concept, which gives fair business cooperation between two parties should be analyzed from its foundation. *Mudhārabah* is one of the PLS products can be taken an example for the study. This study will explore basis characteristics of *mudhārabah* in Islamic banking.

Mudhārabah Contract

Mudhārabah has been known in the early of Islamic history as practiced in Arabian peninsula. Some terms were used such *qirād* in Hijaz and *mudhārabah* in Iraq. When Prophet Muhammad PBUH becomes trader, he used *Mudhārabah* contract with Khadijah. From Shari'ah it can absolutely be practiced either from Qur'an, Sunnah or Ijma.⁵ Khadijah entrusted him to sell her goods to outside of Mekkah. In this case, Khadijah is *shāhibul māl* (investor) and

³Ziauddin Ahmad, 'The Present State of Islamic Finance Movement,' *Journal of Islamic Banking and Finance*, Autumn: (1985), 7-48; Abdullah Saeed, "Indonesian Islamic Banking in Historical and Legal Context, ed. Timothy Lindsey in *Indonesia Law and Society* (Australia: Federation Press, 1999), 330.

⁴Ibid, 229-330.

⁵Adiwarman Azwar Karim, *Bank Islam: Analisis Fiqih dan Keuangan*, 192.

Prophet Muhammad PBUH becomes *Mudhārib* (manager).⁶ With his outstanding entrepreneurship skill Muhammad (pbuh) successfully generated a lot of profits for Khadijah's business.

Mudhārabah is contract between two parties, where one party provide capital (*shāhibul māl*) and second party (*Mudhārib*) provides work or effort in business. One of the characteristics of *Mudhārabah* is fair business because Profit and loss are borne by two parties; If they get profit, they will share as pre-determined contract. If they lose the business, they will lose capital (*shāhibul māl*) and work (*Mudhārib*).

In legal rulling, Islam allows the contract as mentioned Qur'an and Sunnah. In Surah Muzammil, 20 Allah says:

وَأَخْرُونَ يَضْرِبُونَ فِي الْأَرْضِ يَبْتَغُونَ مِنْ فَضْلِ اللَّهِ

"...He has known that there will be among you those who are ill and others traveling throughout the land seeking [something] of the bounty of Allah and others fighting for the cause of Allah...." In hadist says "Three (things) have blessings: Sale of credit, *Muqāradah* (*Mudhārabah*) and mixing wheat with barley for home not for sale" (Hadist narrated by Ibn Majjah).

In Indonesian legal, bank in basis of Profit and Loss Sharing (PLS) is mentioned in Act No. 7 of 1992 concerning banking as amended by Act No. 10 of 1998. Specifically, it is regulated in Act No. 21 of 2008 on Shari'ah Banking.⁷ *Mudhārabah* in the explanation of article 19 in Act No. 21 of 2008 is cooperation contract between first party (*mālik, shāhib al-māl*, or Islamic bank) provides all capital and second party (*'āmil, mudhārib* or customer) becomes manager of fund by sharing business profit in agreed contract. All lost will be borne by Islamic banks unless the second party did it by intension.⁸

In Bank Indonesia regulation number 9/19/PBI/2007 about implementation of Shari'ah principles in collecting and distributing fund and Shari'ah bank services, as amended by 10/16/PBI/2008 financing is concerning Implementation of Sharia Principles in the activities of funds collection and fund distribution and service

⁶Ibid, 204.

⁷Abdul Ghafur Anshori, *Hukum Perjanjian di Indonesia: Konsep, Regulasi, dan Implementasi* (Yogyakarta: Gadjah Mada University Press, 2009), 103.

⁸Ibid, 104.

provision of Sharia Banks. In article 1 number 3 explains that financing is provision of funds or receiveable that can be through the investment based on *mudhārabah* or *mushārahah*.

Bank Indonesia regulation number 10/14/DPbS, March 17, 2008 explains that flow of fund activity in financing based on *mudhārabah* has certains requirements as mentioned in below statement:⁹

1. Bank shall act as fund owner (*shāhib al-māl*) that provides funds for working capital, and customer shall act as fund manager (*mudhārib*) in the business activities;
2. Bank shall retain rights in the supervision and development of customer's business even though it shall not directly participate in the management of customers business activities. For example, Bank is entitled to review and to request evidence related to business report based on reliable supporting documents;
3. Profit sharing ratio from fund management shall be specified in advance;
4. The agreed ratio of profit sharing may not be changed in the course of investment period, unless upon mutual agreement of both parties;
5. Term of financing based on *Mudhārabah*, fund repayment and profit sharing ratio shall be determined in accordance with the agreement between Bank and customer;
6. Financing based on *Mudhārabah* agreement will be provided in cash and/or goods and not in the form of receivables or claims;
7. In the event where financing based on *ā* agreement is provided in the form of cash, the amount must be clearly stated;
8. In the event where financing based on *Mudhārabah* agreement is provided in the form of goods, the concerned goods must be appraised based on market value (net realizable value) and the amount must be clearly stated;
9. Repayment of financing based on *Mudhārabah* agreement is conducted in two ways: in installment or bullet payment based on the term of financing based on *Mudhārabah* agreement.

⁹<http://www.bi.go.id/en/perbankan/syariah/Documents/>, accessed on December 12, 2016.

10. Profit sharing is conducted by referring to the business report with the reliable supporting document;
11. and Loss of customer's business that can be borne by Bank as fund owner (shahibul maal) is maximum the same amount as the financing provided (ra'sul maal).

The Nature of *Mudhārabah* Capital

Under *mudhārabah*, the depositors provide the capital for bank to invest in profitable business which are Shari'ah compliant. The capital should preferably be in the form of legal tender money, because capital in the form of commodities may lead to uncertainties and disputes.¹⁰

Majority of jurists agree that capital in *mudhārabah* should be in the form of gold, silver and money, not in debts and commodities.¹¹ It is also written in AAOIFI that a debt owed by fund manager (*mudhārib*) or another party to the capital provider as capital in *mudhārabah* contract.¹² Therefore, it begins with money and ends with money too till the profit and loss appear between two parties.¹³

Types of *Mudhārabah*

Mudhārabah can be divided into two types: restricted (*muqayyadah*) and unrestricted (*muthlaqah*) *Mudhārabah*. The first type is that fund owner (*shāhib al-māl*) provides particular business and fund manager (*mudhārib*) undertakes the business specified only for items and conditions and time by fund owner (*shāhib al-māl*).¹⁴ Second type is that fund owner (*shāhib al-māl*) has left it open for fund manager (*mudhārib*) to undertake any business wishes, fund manager (*mudhārib*) shall be authorized to invest the funds in any business he deems it.¹⁵

¹⁰Muhammad Ayyub, *Understanding Islamic Finance* (England: John Wiley & Sons Ltd, 2007), 323.

¹¹Rafiq Yunus Misri, *Fiqh Al-Muāmalah al-Māliyah* (Damskus: Daru; Qalam, 2005), 228.

¹²AAOIFI, 2004-5a, Standard on *mudhārabah*, clause 7/3.

¹³Ibid.

¹⁴Ibid, 324.

¹⁵Ibid.

a. Restricted (*muqayyadah*) *Mudhārabah*

It can be practiced into two specific financing: *mudhārabah muqayyadah* on balance sheet, and *mudhārabah muqayyadah* off balance sheet. Scheme of *mudhārabah muqayyadah* on balance sheet is the flow of funds from the investor customer to the Islamic bank in the form of a special deposit (restricted investment) is set by customer in certain requirements that must be complied with by the Islamic bank. For example required to be used on a particular business, or required to be used with a particular contract, or required to be used on a particular customer.¹⁶ For example, customer deposits his fund *mudhārabah muqayyadah* on balance sheet Rp. 1.000.000.000 for project of highway infrastructure within ten years. So there are certain requirements given by customer to bank such as type and time of project. Furthermore, *mudhārabah muqayyadah* off balance sheet is contract that fund owner (*shāhib al-māl*) decides specific project, time and fund manager (*mudhārib*), where bank shall intermediate between fund owner (*shāhib al-māl*) and fund manager (*mudhārib*). By then, Islamic bank in only act as agent for them and gets fee for its service.

b. Unrestricted (*muthlaqah*) *Mudhārabah*

It is the cooperation between fund owner (*shāhib al-māl*) and fund manager (*mudhārib*) that business activities are open, not limited to specific business, time and place. If the scheme of *mudhārabah muthlaqah* explains that the entire flow of funds from customer of the Islamic bank should not be contained certain restrictions on business execution financed and contract used. In other words, the Islamic bank has the right and full freedom in managing and investing investor customer's fund into various business sectors that are expected to earn a profit. This flow of fund can be a saving and deposit, in the form of *mudhārabah* saving and *mudhārabah* time deposit.¹⁷

¹⁶Adiwarman Azwar Karim, *Bank Islam*, 314.

¹⁷Adiwarman Azwar Karim, *Bank Islam*, 317.

Table 1: Product of *Mudhârabah Muthlaqah*

| <i>Mudhârabah</i> saving | <i>Mudhârabah</i> time deposit |
|---|---|
| Islamic bank provide service of saving of fund to customers that will be used later for many reasons. <i>Mudhârabah</i> saving can be taken at any time by the saver in accordance with the agreed treaty, but is not allowed to run into a negative balance. | <i>Mudhârabah</i> time deposit can only be disbursed in accordance with the agreed time period. Deposits were extended after the due date, will be treated the same as a new deposit, but when the contract has been included automatic renewal, a new contract is not need to be made. ¹⁸ |

Calculation of Profit Sharing Ratio

Main characteristic of PLS is Profit and loss are borne by two parties, which the fund owner (*shāhib al-māl*) shall bear capital and fund manager (*mudhārib*) shall bear work. Some basic principles of PLS as mentioned by Utsmani: 1) PLS does not mean giving loan, but it is partnership in business; 2) fund owner (*shāhib al-māl*) or investor shall bear risk of loss depends on financing proportion; 3) All business partners are free to determine profit ratio with the agreed decision to each party which can be different from financing ratio; and 4) Loss that will be borne by them should be based on investment proportion.

The agreement of profit sharing that is proportional between fund owner and fund manager (*mudhārib*) and (*shāhib al-māl*) is form of contract in *mudhârabah*. It is the only one requirement associates with *sine qua non mudhârabah* contract that the profit sharing between them is proportional.¹⁹

Nisbah of profit sharing is result from the negotiation between fund owner (*shāhib al-māl*) and fund manager (*mudhārib*) and (*shāhib al-māl*) by determining the potential project that will be financed. Determinant factors of *nisbah* level are *'iwad* (counter value) from its project such as risk (*ghourm*), value added of work, and guarantee (*dhāman*). By then, number of *nisbah* is not sacred number that is unknown its origin, but rasional number is agreed

¹⁸Wirosa, *Penghimpunan Dana dan Distribusi Hasil Usaha Bank Syariah* (Jakarta: Grasindo, 2005), 56.

¹⁹Ascarya, *Akad dan Produk Bank*, 49.

by all parties in determining the project that will be financed from all sides.²⁰

The profit sharing depends on calculation that can be calculated by the concept of revenue sharing and profit and loss sharing. The basic calculation of revenue sharing is the calculation based on sale or gross revenue before deducted all expenses. The formula calculation is revenue sharing is the agree nisbah times to gross revenue. For instance, the agreed *nisbah* is 10% for Islamic bank and 90% for customer. If Islamic bank gets revenue Rp. 10.000.000, the profit sharing will be obtained is 10% X Rp. 10.000.000 = Rp. 1.000.000, and for customer is Rp. 9.000.000.

The basic calculation of profit and loss sharing is based on profit or loss. Islamic bank and customer will obtain profit in business, while they shall bear loss when the business is facing loss. For instance, if total expenses or cost is Rp. 9.000.000, the profit will be obtained by customer is Rp. 900.000 (90 % X (Rp. 10.000.000 – Rp. 9.000.000)), and by Islamic bank is Rp. 100.000.²¹

By considering the benefit and current condition if Islamic banks, revenue sharing is more recommended by Fatwa od DSN MUI No. 003 year 2000.²²

Differences between Profit and Loss Sharing

As alternative for interest system in Conventional economic, Islamic economics provides profit and loss sharing. It is partnership contract that fund owner (*shāhib al-māl*) provides capital (surplus spending unit) to *mudhārib* (deficit spending unit) who will run fund manager (*mudhārib*).

Most people are still asking whether interest is categorized as as usury. Usury emphasizes more on taking excessive return return from loan, while interest in accordance with some people is something normal to protect value of currency.²³ Moreover, the concept of interest has been known in medieval time, which word

²⁰Ibid, 67.

²¹Ismail, *Perbankan Syari'ah* (Jakarta: Kencana, 2011), 98.

²²Laode Hasanu, Anita Priantina & Dewi Febriani, "Improving Sharia Risk Compliance: Proposing Daily Index for Mudhārabah Contract in Islamic Banks in Indonesia," *Tazkia Islamic Finance and Business Review (TIFBR)*, Vol. 7 No. 1, (2012), 54.

²³Abdul Ghafur Anshori, *Hukum Perjanjian di Indonesia: Konsep, Regulasi, dan Implementasi*, 17.

is derived from *interesse* (latin) means compensation on loss and payment. In the other words, a compensation is paid for damage or loss that is borne by lender because of borrower who is failure to return back the money in due time.

Usury is derived from Latin, *usura* or *usuria* that means payment of loan. In Greek is called as *tokos*. In the context of loan, it is price that must be paid cause of loan either in the form of commodity or money more than real price. It is common practice performed by most people.²⁴

By these explanations, it can be concluded that interest and usury constitute two concept with one spirit: return that is expected by lender on commodity and money loan, whereas actually those items have no effort that produce something without risk. By then, interest and usury can be categorized as *ribā* because of gaining profit without risk or effort. So, making profit with interest rate is known with the term time value of money.

There are three streams or views about the prohibition of usury and interest in Islamic law, namely a pragmatic, conservative, and socio-economic point of view. All views can be explained as follows:

a. Pragmatic View

According to the pragmatic view, al-Qur'ān prohibits usury which occurred during the previous era of Islam, but does not prohibit interest in the modern financial system. Allah Says:

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلْ الرِّبَا أَضْعَافًا مُضَاعَفَةً، وَاتَّقُوا اللَّهَ لَعَلَّكُمْ تُفْلِحُونَ

“you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful.” (Al-Imrān: 130)

Thus, the pragmatic view justify the imposition of bank interest is valid. Which is impermissible by Islamic law is the imposition of excessive interest because there is an element of exploitation. Moreover, the imposition of bank interest for the benefit of the economic development of Muslim countries is legal too.²⁵

²⁴Ibid, 18.

²⁵Abdul Ghafur Anshori, *Hukum Perjanjian di Indonesia: Konsep, Regulasi, dan Implementasi*, 20.

b. Conservative View

The core of the conservative view is that *ribā* is interest and usury. Each pre-determined compensation for the deferred payment on the loan is *ribā*. Conservative views distinguish *ribā* into *nasiah* and *fadhī*. *Ribā nasiah* associated with additional fees charged to the loan transaction, while *ribā fadhī* is related to the additional costs charged to the sales transaction.

c. Socio-economic View

Socioeconomic view prohibits bank interest in the pretext of a socio-economically. Important argument raised by this view that the interest has a tendency to accumulate wealth in the hands of the few people. Furthermore, the socio-economic argues that the principles of Islamic finance require the lender and the borrower at risk or in other words the risk of profit appears along with cost and revenue.²⁶ According Syrian Potician, Doulibi, differentiates loan for consumption and production, which for consumption is impermissible and production is permissible. This argument is based on verses of the Qur'ān concerning *ribā* is felt down within the context of freeing the poor, and poor communities, and those who, being trapped in debt, unable to pay off its debts. Therefore, they agreed that Islam prohibits *ribā* related to loans for consumption.

The implication is that interest and PLS has many differences in the banking practice. Some differences can be shown in table below:

Table 2: The Differences between Interest and PLS

| | |
|--|--|
| Determination of interest is made at the time the contract by the assumption that business will be always profitable | Determination of profit ratio (<i>nisbah</i>) was agreed at the time of the contract based on possible profit or loss. |
| The percentage rate is based on the amount of funds / capital lent | <i>Nisbah</i> is based on on the amount of profit earned |

²⁶Ibid, 21.

²⁷Ghada Ben Zeineb and Sami Mensi, " Does the PLS Paradigm Spur the Islamic Banks Vs Conventional Banks Soundness: Case of the Global Financial Crisis," *Journal of Economics and Development Studies*, Vol. 2 No. 3. (2014): 177-192.

| | |
|---|--|
| Ratio of interest is floating based on economic condition | Ratio of PLS is fixed as long as contract exists |
| The payment of interest is fixed without determination of business run by borrower obtains profit or loss | The PLS is based on business run by two parties. Profit and loss will be borne together. |
| Amount of interest payment cannot increase even the profit is double | Amount of profit sharing is increasing depends on increase in profit |
| The existence of interest is impermissible by all religion | PLS is valid |

Source: Ascarya, 27

Profit and Loss Sharing as the Basic Characteristic in Islamic Banking

PLS gives the function of Islamic bank is not only as intermediary financial institution, but also partnership financial institution to society that can be realized into capital equity, trade and other services such as kafalah, wakalah, etc. There are some basic characteristic of Islamic banking from PLS.

Firstly, PLS is just system of Islamic banking rather than interest in Conventional banking. Because profit and loss are shared by two parties: if they obtain the profit, they will share based on *nisbah*, but if they got loss, they will lose the capital (fund owner) and work (fund manager). As mentioned in previous explanation that no one claim any profit without incurring risk in business known is Islamic legal maxim *al-ghoum bil al-ghourm*. It is in line with statement that interest and usuary can be categorized as *ribâ* because of gaining profit without risk or effort.

Secondly, PLS allows more efficient allocation of capital because the return of capital based on productivity and viability of the project, not interest rate.²⁷ So, fund owner (*shâhib al-mâl*) and fund manager (*mudhârib*) and (*shâhib al-mâl*) as partner should be work together to maximize the profit.

Thirdly, PLS is productive contract that support who have business either micro, middle or macro level. It is partnership contract between investor and fund manager or business owner who need capital to expand the business. In the case of Islamic

banking, the Islamic banks become investor to finance the business project run by customers.

Fourthly, PLS is medium to reach the objective of Islamic economic through Islamic banking. One of the objective is to prosper the other people through mutual cooperation in business by fair and just. In long term will contribute to development of economy in the country.

Conclusion

Mudhârabah constitutes one of the products in Islamic banking. It is a cooperation contract between two parties, where one party (*rabbul mâl*) provides 100 % fund and other (*mudhârib*) provide work. It has certain basic characteristics in Islamic banking such as PLS as just system, as tool of efficient allocation of capital, as productive contract that support who have business either micro, middle or macro level, and as medium to reach the objective of Islamic economics.

It is recommended to Islamic banks to more provide product of profit and loss sharing, rather than other product. In fact, *mudhârabah* is less preferable compared to Islamic debt financing instruments in Islamic banking because of agency problems and risk. Therefore, the role of Islamic corporate governance (GCG) is needed to mitigate agency problems in Islamic financing instruments especially in *mudhârabah* (Profit and loss sharing) contract.

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