

The determinant of equity financing in sharia banking and sharia business units

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Abstract

Equity financing plays an important role in mobilizing financing in the real sector. The core business of sharia banking is based on the real sector, but the financing portion in sharia banking is still dominated by debt financing. This study aims to analyze the factors that affect equity financing in General Sharia Bank (BUS) and Sharia Business Unit (SBU) in Indonesia. This study uses Error Correction Model. The results show that in the long-term model of Third Party Fund (DPK), Finance to Deposit Ratio (FDR), Non-Performing Financing (NPF), Inflation and Interest Rates Credit of Conventional Bank (SBK) has a significant positive effect on equity financing. BOPO variables (Operating Cost Ratio to the Operating Income) and Return on Assets (ROA) have a positive but not significant effect on equity financing. The DPK and FDR variables have a positive and significant effect on equity financing on the short-term model.

Introduction

The sharia banking industry in Indonesia is experiencing significant growth and improvement from year to year. Starting with the founding of Bank Muamalat in 1992 as the first Sharia bank that became the forerunner of the growth of sharia banking industry in Indonesia. Based on sharia banking statistics released by the Financial Services Authority (OJK) shows that the total assets of sharia banking continue to increase to IDR 356,504 trillion in 2016. Also, there is an escalation in the number of General Sharia Bank (BUS) to 13 and the number of Sharia Business Unit (UUS) to 21.

As an institution that has an intermediary function, it makes sharia banking as one of the important elements in supporting the economy. Therefore, the increasing number of sharia banking will affect the total assets, especially Third Party Funds (DPK) that have been collected from the public. Calculated from 2011 to 2016 the number of deposits that have been collected by Sharia banking is increasing every year and reach the number of IDR 206.407 trillion in 2016 (OJK, 2016).

On the other hand, the number of funds disbursed for financing also increased along with the increase in the number of DPK. As of 2016, the amount of financing distributed by sharia banking reached IDR 177.482 trillion. It will affect the Finance to Deposit Ratio (FDR), which is the ratio between financing distributed by the number of DPK that has been collected and is one of the criteria in the assessment of banking performance.

Financing in sharia banking is divided into four categories based on contract type, namely equity financing with *mudharabah* and *musyarakah* contract, debt financing with *murabahah*, *istishna'* and *qardh* contracts, financing with *ijarah* contract and the last is Financing with *salam* contract (UU No. 21 of 2008). Equity financing is a type of sharia financing product where financing is based on the principle of profit sharing, which includes *mudharabah* financing and *musyarakah* financing. In general, this type of financing is used for investment or working capital.

According to Yusof (2009), sharia banking should not only orient to profit but also must prioritize the social goals to achieve prosperity and equality. The existence of equity financing is expected to encourage the realization of the goal of sharia banking in maximizing its function as an intermediary institution (Shaikh, 2017). Nevertheless, it is unfortunate that in fact the financing of sharia banking is still dominated by debt financing with *Murabaha* contract which is 58% of total financing distributed, and equity financing only has 38% portion. It is shown in Figure 1.

Sharia banking still considers that the distribution of equity financing has a considerable risk so that the proportion of financing tends to be smaller. Whereas, based on the research of Othman *et al.* (2015), which examines the efficiency of sharia banking in Malaysia and Indonesia shows that the performance of sharia banking will tend to be more efficient if the proportion of equity financing they distribute is greater.

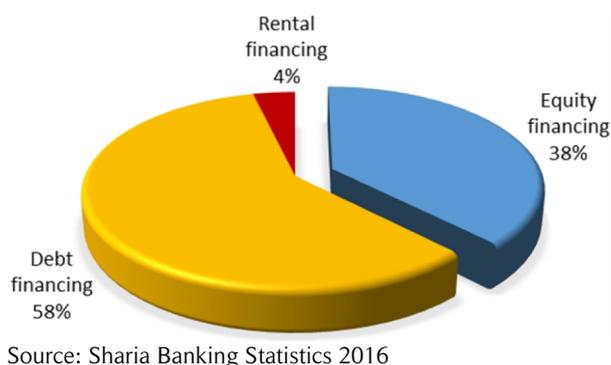


Figure 1. Proportion of financing distributed by BUS and UUS based on contract type of 2016 period

Due to the high portion of non-equity financing which is dominated by *murabahah* contract, there is an impression in the community that financing through sharia bank is no different from financing through a conventional bank. Theoretically, sharia banking is profit-and-loss sharing (PLS) system, but practically it is not very different from conventional banking (Chong & Liu, 2009). Malik *et al* (2011) argued that much of the financing offered by sharia banks actually bear a closer semblance to debt instruments than to profit-and-loss sharing. Equity financing should be the main financing for sharia banking. In addition, the financing that differentiates the sharia banking system with conventional banking because it is a financing based on the real sector. It does not reflect the real core business of sharia banking. So that it is necessary to study the general picture of equity financing as well as what factors which affect BUS and UUS in Indonesia.

The scope of this research is limited to equity financing which is financing with *mudharabah* and *musyarakah* contract. *Mudharabah* financing is a joint venture between two or more parties, where the first party acts as the owner of the fund (shahibul maal) which provides all financial capital and the second party as the fund manager (mudharib) (Ariff & Iqbal, 2011). The profit earned is divided according to the agreement set in a contract and usually in the form of a percentage (nisbah). If the business runs a loss then the loss is borne by the shahibul mal as long as the loss is not caused by the negligence of shahibul mal. Zuhayli, (2007) said that The financing by *musyarakah* contract is financing involving the participation of two or more persons in a certain business with a certain amount of capital stipulated under the agreement to jointly run a business and share the profit or loss in the part which is determined. Both types of financing should be a priority in the sharia banking industry, but in fact, it has not been done.

Meanwhile, the scope of sharia banking in this study is limited to BUS and UUS from January 2010 to June 2015. The factors used are variables that describe internal banking performance including Finance to Deposit Ratio (FDR), Non-Performing Financing (NPF), Return on Asset (ROA), Operational Costs and Operational Income (BOPO) and DPK. Besides the internal variables of banking, the variables that describe the external condition of banks, inflation, and credit interest rate in conventional banking can also affect equity financing.

Research Methods

This study uses secondary data in the form of time series data derived from Sharia Banking Statistics OJK and Banking Statistics of Bank of Indonesia. The data is analyzed monthly from January 2010 to December 2015. The methods for analyzing the factors which are affecting equity financing in BUS and UUS in Indonesia is Engel-Granger analysis for long-term equity financing balance, and Error Correction Model (ECM) for short-term equity financing balance.

Error correction model (ECM)

ECM is one of the most widely applied dynamic models in economic analysis. This model aims to overcome the problems in time series data, which is not stationary and spurious regression.

Before the ECM method performed, it conducted a test of time series data by using unit root test, also known as Dickey-Fuller (DF) and Augmented Dicky Fuller (ADF) test. If all the variables of stationary research on the unit root test, then the co-integration test is done to determine the balance or long-term stability between the observed variables and the direction of influence given by those variables to equity financing.

One of the important assumptions in estimating the parameters of the regression model with the least squares method is the homoscedastic residual error; it means that the independent variable (Y_t) must be constant ($\text{Var}(Y_t) = \sigma^2$). Another assumption is that there is no correlation between errors, which also means there is no correlation between Y_t variables with Y_{t-1} or Y_t others (no autocorrelation).

Data stationarity test

The data stationarity test is done by ADF test by looking at the probability of each research variable. If the probability of each variable exceeds the critical value at the real level ($\alpha = 0.05$) at the level, then the variable is stationary at the level. However, if it is not stationary at the level, it is re-examined in the first difference. The result shows that the variable of *Mudharabah* and *Musyarakah* financing, DPK, FDR, NPF, ROA, BOPO, inflation, and lending rates in conventional banking are not stationary at the level but stationary in the first difference. Stationary data in the first difference can be concluded that it co-integrated to the degree one. Thus, the requirement of a co-integrated regression relationship has been fulfilled.

Co-integration test

Co-integration is a long-term relationship between non-stationary variables. A variable system is said to be co-integrated if some of these variables (at least one variable) are integrated to degree one and apply linear combinations of the variable system are integrated at a zero degree, i.e., disequilibrium error or residual (u) is stationary. Engel and Granger also stated that a co-integration test could be considered as a preliminary test to avoid spurious regression.

Many ways can be done in the test co-integration; there are Engel-Granger Co-integration Test, Johansen Co-integration Test, and Co-integrating Regression Durbin-Watson Test. The Co-integration test conducted in this research is Engel-Granger Co-integration Test because the equation used is a single equation. The Engel-Granger co-integration method performed used in this study is the ADF method consists of two stages. The first stage, regressing the Ordinary Least Square (OLS) equation and obtaining residuals from the equation. The second stage, using the ADF Test method to test the stationarity in the residual as in the research variables.

If the stationary residual at the level, it can be concluded that the combination of research variables is stationary. It means that although the variables used are not stationary, but in the long term, those variables tend to be in balance. The model used in this research is:

$$\text{LnPMM}_t = \beta_0 + \beta_1 \text{LnDPK}_t + \beta_2 \text{FDR}_t + \beta_3 \text{NPF}_t + \beta_4 \text{ROA}_t + \beta_5 \text{BOPO}_t + \beta_6 \text{INF}_t + \beta_7 \text{SBK}_t + \varepsilon_t \quad (1)$$

Notes:

LnPMM = Logarithm Natural Total of *Mudharabah* and *Musyarakah* financing in BUS and UUS (rupiah billion)

β_0 = Intercept

β_i = The coefficients of the variable i

LnDPK = Logarithm Natural Total of BUS and UUS (billion rupiahs) Third Party Funds

FDR = Finance to Deposit Ratio (percent)

NPF = Non-Performing Financing (percent)

ROA = Return On Asset (percent)

BOPO = Ratio of Operating Expenses to Operating Income (percent)

INF = Inflation (percent)

SBK = Lending Rate (percent)

ε_t = Galat (error)

Error correction model (ECM)

ECM model aims to overcome the problems in time series data that is not stationary. ECM appears to address the short-term and long-term effects of consistent estimations. ECM model used in this study is to see the short-term relationship of DPK, FDR, NPF, ROA, BOPO, inflation, and credit interest rate of conventional banking to equity financing. The short-term research model in this study is:

$$\Delta \text{LnPMM}_t = \alpha_1 \Delta \text{LnDPK}_t + \alpha_2 \Delta \text{FDR}_t + \alpha_3 \Delta \text{NPF}_t + \alpha_4 \Delta \text{ROA}_t + \alpha_5 \Delta \text{BOPO}_t + \alpha_6 \Delta \text{INF}_t + \alpha_7 \Delta \text{SBK}_t + u_{t-1} + \varepsilon_t \quad (2)$$

Notes:

$\Delta \ln PMM_t$ = Differentiation in Natural Logarithm of Total financing of *Mudharabah* and *Musyarakah*

$\Delta \ln DPK_t$ = Differentiation in Natural Logarithm Total third party funds of BUS and UUS

ΔFDR_t = Differentiation in *Finance to Deposit Ratio*

ΔNPF_t = Differentiation in *Non Performing Financing*

ΔROA_t = Differentiation in *Return On Asset*

$\Delta BOPO_t$ = Differentiation in Operating Expense Ratio to Operating Income

ΔINF_t = Differentiation in Inflation

ΔSBK_t = Differentiation in conventional bank credit interest

u_{t-1} = *Error Correction Term* (residual)

$\alpha_1, \dots, \alpha_7$ = Variable coefficient

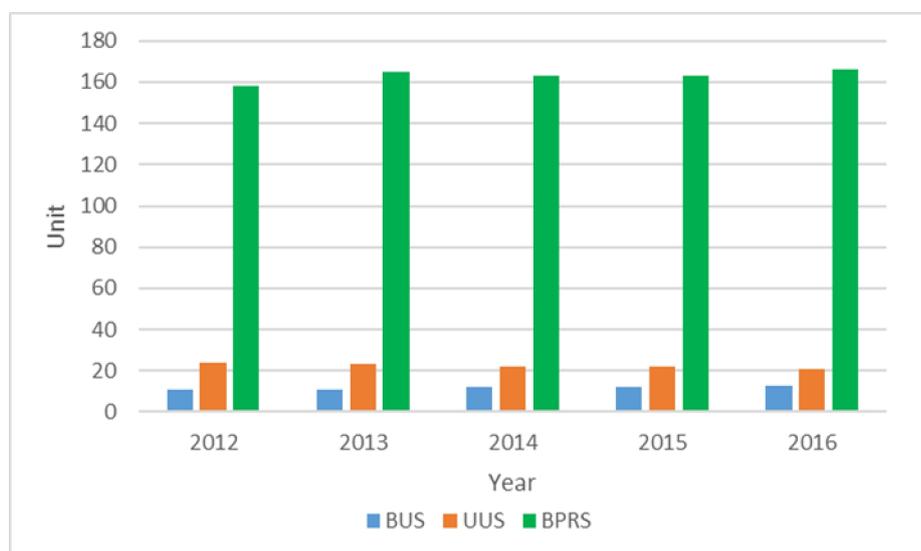
ε_t = *Error*

The variables in this study are as follows. *Mudharabah* and *Musyarakah* financing represent total financing on *Mudharabah* and *Musyarakah* contracts distributed by BUS and UUS, expressed in billions of rupiah. Third Party Funds (TPF) represents the total funds collected by BUS and UUS from customers, expressed in billions of rupiah. Finance to Deposit Ratio (FDR) is the ratio of sharia banking finance that compares the financing disbursed and the amount of DPK that collected, expressed in percent. Non-Performing Financing (NPF) is a financial ratio that describes the amount of nonperforming financing to total financing disbursed by sharia banks, expressed in percent. Return on Assets (ROA) is a financial ratio that measures the ability of banks in obtaining overall profits, expressed in percent. The ratio of Operating Expense to Operating Income (BOPO) is a calculation of bank efficiency by comparing operating expense and operating income, expressed in percent. The rate of inflation is a process of rising prices prevailing in the Indonesian economy, expressed in percent. Conventional bank credit interest (BCI) rate is the credit interest rate of conventional commercial banks in Indonesia for working capital, expressed in percent.

Results and Discussion

The development of equity financing in BUS and UUS in Indonesia

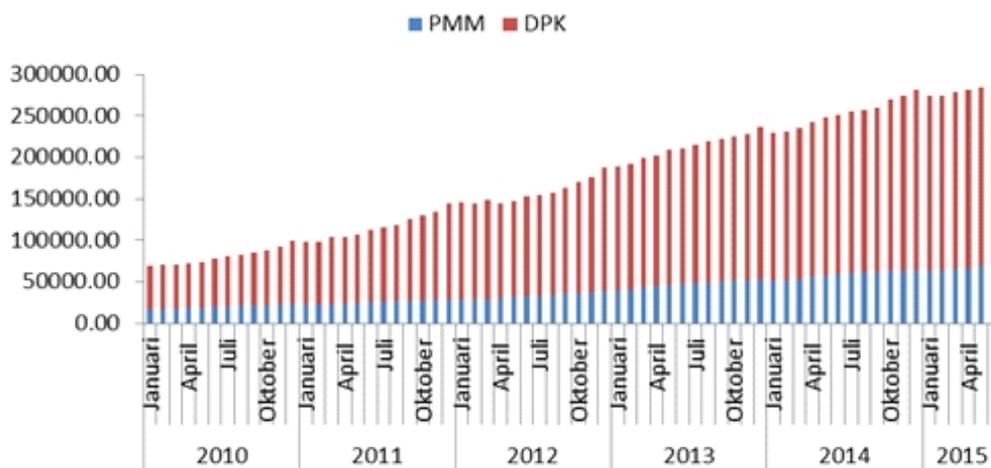
The establishment of Bank Muamalat in Indonesia in 1992 was the beginning of the growth of sharia banking. Since the government issued Law Number 21 of 2008, that one of the contents requires all conventional banks to have Sharia Business Units, the number of sharia banks have established. According to Sharia Banking Statistics data published by the Financial Services Authority until December 2016, there are 13 General Sharia Banks (BUS), 21 Sharia Business Units (UUS), and 166 Sharia Financing People Banks (BPRS). The number of UUS has decreased since conventional banks tend to change and develop UUS into BUS.



Source: Sharia Banking Statistics of FSA 2015

Figure 2. The number of BUS, UUS, and BPRS in Indonesia for the period 2012-2016

The numbers of banks are increased, followed by the increasing number of sharia banking offices from year to year. By December 2016, there were 1869 BUS offices, 322 UUS offices, and 453 BPRS offices. Sharia banking office network continues to spread to all areas in Indonesia so that it can serve all bank customers both in the collection of DPK and in disbursing financing. The amount of DPK of Sharia banking has increased along with the increase of the number of banks and the number of office networks. The increase in total DPK is followed by an increase of total equity financing during the study period.



Source: Sharia Banking Statistics of FSA 2015

Figure 3: Total DPK and equity financing at BUS and UUS period January 2010-June 2015

Financial ratios in sharia banking illustrate the development of BUS and UUS performance during the study period. The financial ratios used in this study are Non-Performing Financing (NPF), Finance to Deposit Ratio (FDR), Return on Assets (ROA) and Operating Expense Ratio to Operating Income (BOPO).

FDR is the financial ratio to sharia banking that compares the amount of financing disbursed to the number of funds collected. The FDR variable shows the banking performance and liquidity of sharia banking. The development of FDR in BUS and UUS increased every year during the research period. In SPS data in June 2015, FDR reached 96.52 percent. This shows that the liquidity of sharia banking is very high.

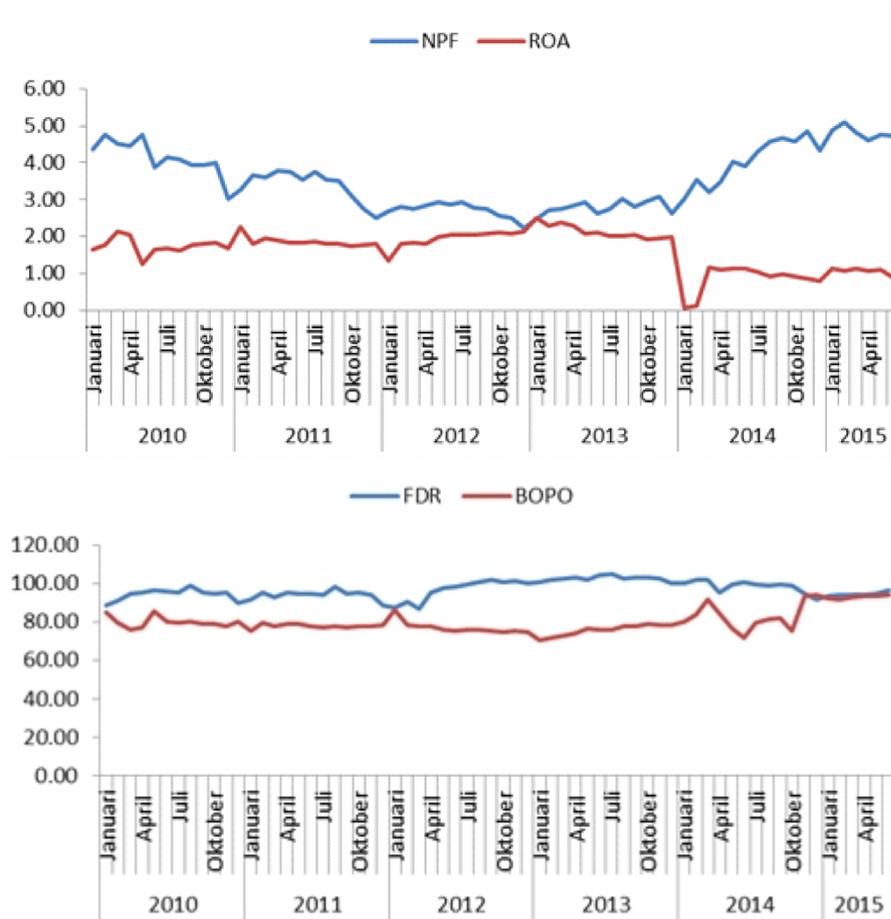
NPF is one of the financial ratios in sharia banking that compares the number of nonperforming financing to total financing disbursed. The growth of NPF in BUS and UUS increased until February 2015 reaching 5.10 percent. However, until June 2015, NPF decreased to 4.73 percent.

ROA is a financial ratio that describes the level of bank profitability to measure the level of business efficiency and profitability achieved by the bank. The development of ROA on BUS and UUS decreased in the second quarter of 2015 by 0.50 percent. The decline in ROA is due to lower earnings gains in line with slowing economic growth.

Operational Expense Ratio to Operating Income is a financial ratio that describes bank profitability. This ratio is used to measure the level of efficiency and ability of banks in conducting their operations. The development of BOPO in BUS and UUS increased until June 2015 reached 94.22 percent.

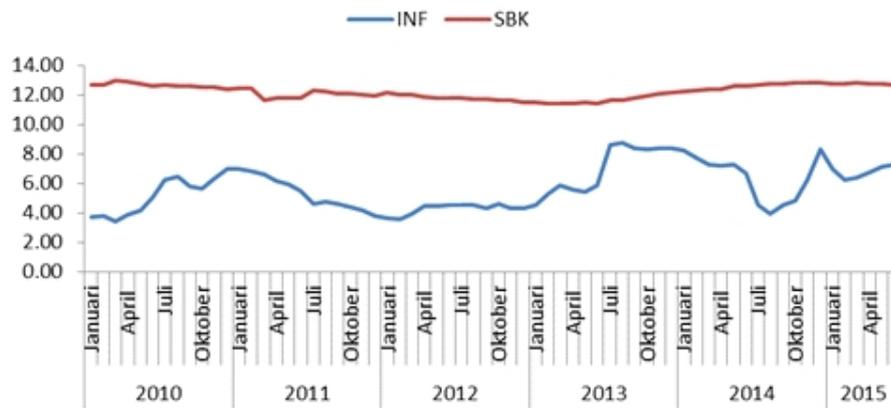
The inflation rate can be interpreted as increasing prices in general and continuously. An increase in the price of one or two items alone cannot be called inflation unless the increase extends (or causes price increases) to other goods. The inflation rate is increasing every year, but there is a decrease in August 2014 of 3.99 percent, while the credit interest rate in conventional banks is increasing every year in line with the increase of credit.

Before analyzing the factors affecting equity financing of BUS and UUS, several actions are done, such as stationarity testing on research variables, regressing long-term models, testing the residual stationarity of long-term model regression equations, testing short-term models or ECM, and regression of ECM models.



Source: Statistics of Sharia Banking OJK 2015

Figure 4: The Development of Financial Ratios in BUS and UUS in Indonesia for January 2010-June 2015



Source: Bank Indonesia (2015)

Figure 5: The development of inflation rate and conventional bank credit interest rates from January 2010 to June 2015

Data stationarity test

Stationarity testing on research variables is done using ADF Test on unit root test. The first stationarity test is done at the level. The results of the ADF Test in testing the stationarity of research variables at the level are as follows.

Table 1. Data Stationarity Test

Variables	ADF t-stat Value	Mac Kinnon Value			Notes
		1%	5%	10%	
LNPMM	-1.356603	-4.105534	-3.480463	-3.168093	Not Stationary
LNDPK	-0.187465	-4.105534	-3.480463	-3.168093	Not Stationary
FDR	-2.817158	-3.534868	-2.906923	-2.591006	Not Stationary
NPF	-1.301263	-3.534868	-2.906923	-2.591006	Not Stationary
ROA	-2.522575	-3.534868	-2.906923	-2.591006	Not Stationary
BOPO	-2.367877	-3.534868	-2.906923	-2.591006	Not Stationary
INF	-2.647875	-3.536587	-2.907660	-2.591396	Not Stationary
SBK	-1.194308	-3.534868	-2.906923	-2.591006	Not Stationary

The results show that the research variables either dependent variable or independent variable is not stationary at the level. Then, stationarity testing with ADF Tests back to the first difference. The result of stationarity test at first difference is as follows.

Table 2. Result of Stationarity Test at First Difference

Variables	ADF t-stat Value	Mac Kinnon Value			Notes
		1%	5%	10%	
D(LNPMM)	-7.035421	-4.107947	-3.481595	-3.168695	Stationary*
D(LNDPK)	-8.593336	-4.107947	-3.481595	-3.168695	Stationary *
D(FDR)	-9.218619	-3.536587	-2.907660	-2.591396	Stationary *
D(NPF)	-9.954814	-3.536587	-2.907660	-2.591396	Stationary *
D(ROA)	-8.485385	-3.538362	-2.908420	-2.591799	Stationary *
D(BOPO)	-9.685300	-3.536587	-2.907660	-2.591396	Stationary *
D(INF)	-5.912483	-3.536587	-2.907660	-2.591396	Stationary *
D(SBK)	-8.219037	-3.536587	-2.907660	-2.591396	Stationary *

Notes: *stationary at the critical value of Mac Kinnon at $\alpha = 0.05$ level

Co-integration test

The result of stationary ` of the data shows that the variables used in this study are stationary at first difference and the ADF t-statistic value is greater than the critical value of Mac Kinnon. If the stationary variable is at first difference, a co-integration test can be performed. Co-integration test is performed by testing the stationarity of the residual (u) from the long-term equation model using ADF Test. If u is stationary at the level, then it can be concluded that the research model has co-integration. The test results of stationarity u are as follows.

Table 3. Test Results of Stationarity u

Variable	ADF t-stat Value	Mac Kinnon Value			Note
		1%	5%	10%	
<i>u</i>	-5.603565	-2.601024	-1.945903	-1.613543	Stationary

Notes: * stationary at the critical value of Mac Kinnon at $\alpha = 0.05$ level

The stationarity test of u shows that u is stationary at the level and it can be concluded that there is co-integration in the research model. Besides, the concern about the existence of pseudo regression is not proved by the result of stationary test and co-integration test. The implication of the co-integration test is that mutual co-integrated changes can be said to be in a long run equilibrium and have a long-term relationship.

Table 4. Long-Term Model

Variables	Coefficient	Probability
LNDPK	0.892321	0.0000*
FDR	0.009589	0.0000*
NPF	0.052110	0.0000*
ROA	0.012410	0.2135
BOPO	0.000901	0.3104
INF	0.014389	0.0000*
SBK	0.078685	0.0000*
C	-2.204051	0.0000
R-squared		0.997304
Prob (F-statistics)		0.000000

Notes: * indicates significant at $\alpha = 0.05$ level

The result of regression in long-term model shows that variable of DPK, FDR, NPF, inflation, and credit interest rate in the conventional bank have a positive and significant effect on the real level ($\alpha = 0.05$). These variables significantly influence the long-term equity financing. The DPK variable has a positive and significant influence on the real level ($\alpha = 0.05$) to equity financing and has the coefficient value of 0.892321. That means if the DPK increases by 1%, then equity financing will increase by 0.892321% when other variables are considered constant. These findings are in line with the research hypothesis and with Sholikhah *et al.* (2017). DPK is one of the variables that show the performance of banking and is the number of funds collected by sharia banking that will be distributed for financing. This also can be explained in Figure 3, which shows that the amount collected DPK and equity financing given by BUS and UUS has increased and both have positive trends.

FDR variable has a positive and significant effect on the real level ($\alpha = 0.05$) to equity financing and has a coefficient value of 0.009589. That means if FDR increases by 1%, then equity financing will increase by 0.009589% when other variables are considered constant. FDR is one of the financial ratios that show the liquidity of sharia banking that compares the financing disbursed and funds received by banks. If FDR increases, then the amount of financing disbursed will increase the amount of DPK received.

NPF variable has a positive and significant effect on the real level ($\alpha = 0.05$) to equity financing and has a coefficient value of 0.052110. That means if NPF increases by 1% then equity financing will increase by 0.052110% when other variables are considered constant. Theoretically, NPF is one of the variables that shows the performance of sharia banking and the ratio of nonperforming financing with the amount of financing provided. As NPF become higher, it indicates the problem of financing. It results banks will carefully consider and re-evaluate the amount of financing as it brings many losses to them. Due to the small equity-financing portion, the NPF in equity financing is considered to have no significant effect on the financing so that sharia banking is focused on disbursing financing as the number of DPK increases.

Inflation variable has a positive and significant effect on the real level ($\alpha = 0.05$) to equity financing and has a coefficient value of 0.014389. That means if inflation increases 1%, then equity financing will increase by 0.014389% when other variables are considered constant. This finding is not by the hypothesis. Normally, the effect of inflation may rise the bank lending as it indicates the increase of interest rate. The raise of interest rate may lead to the decrease of financing volume (Moussa & Chedia, 2016)

SBK variable has a positive and significant influence on the real level ($\alpha = 0.05$) to equity financing and has a coefficient value of 0.078685. That means if SBK increases 1%, then equity financing will increase by 0.078685% when other variables are considered constant. High interest rates make conventional customers pay substantial interest on loans taken. This condition will have an impact on the increase of sharia bank financing because financing products in sharia bank are considered as substitution of credit in the conventional bank.

The ECM model estimation results have the criteria as a good ECM model because the variable coefficient u has a negative coefficient and a significant probability at the real level ($\alpha = 0.1$). Thus, the model not only has a short-term relationship but also has a relationship in long-term balance. In the ECM model, there are two independent variables, namely DPK and FDR, which have a positive effect on equity financing. The DPK and FDR variables have a significant effect on the real level ($\alpha = 0.05$).

The DPK variable gives positive and significant influence on the real level ($\alpha = 0.05$) to equity financing which has a coefficient of 0.375317. That means if the DPK increases 1%, then equity financing will increase by 0.375317% when other variables are considered constant. It can be explained in Figure 3 that the increase in the number of DPK is followed by total equity financing. These findings are in line with the research hypothesis and results of Sholikhah *et al.* (2017) which states that there is a positive relationship between DPK and financing. In many cases, customer deposit is the main source of bank financing.

Table 5. Short Term Model (ECM)

Variable	Coefficient	Probability
D(LNDPK)	0.375317	0.0034*
D(FDR)	0.004078	0.0005*
D(NPF)	0.004039	0.6505
D(ROA)	0.008237	0.1781
D(BOPO)	0.000203	0.6901
D(INF)	0.003626	0.2413
D(SBK)	0.004571	0.7521
U(-1)	-0.198565	0.0747**
C	0.013129	0.0003
R-squared		0.305799
Prob (F-statistic)		0.005963

Notes: *, ** indicate significant at $\alpha = 0.05$ and 0.10 level

FDR variable gives positive and significant influence on the real level ($\alpha = 0.05$) to equity financing, which has a coefficient of 0.004078. That means if FDR increases 1%, then equity financing will increase by 0.004078% when other variables are considered constant. This is due to the activities of sharia banks that collect deposits and disbursed financing. As the increase in DPK is collected, the financing disbursed will increase. Similarly, the increase is experienced by equity financing. These findings are in line with the research hypothesis that there is a positive relationship between FDR and equity financing.

Conclusion

The development of the amount of equity financing in BUS and UUS in Indonesia increases every year in line with the increase in the amount of Third Party Funds collected. However, the portion of equity financing is still small compared to the total financing disbursed. The financing disbursed is still dominated by debt financing among others by using *murabahah* scheme. Also, the significant variables affecting equity financing in long-term models are deposits, FDR, NPF, inflation, and conventional bank lending rates, where these variables have a positive effect on the real level. However, the findings on NPF and inflation variables are not in line with the research hypothesis. In the short-run model (ECM), the variable that gives positive and significant effect on the real level of equity financing is DPK and FDR.

These findings can be used as advice and input for the government and the Islamic banking to increase further the amount of financing distribution based on equity financing. This cannot be separated from the reason that equity financing should be the main financing for sharia banks and that distinguishes it from conventional banking system because it is financing based on the real sector. Sharia banking, especially BUS and UUS can increase the number of customers in equity financing by "pick up the ball" method so that the financing in the real sector will increase. Also, sharia banking must pay attention to conventional bank credit interest rates and make policies by reducing the equivalent rate of equity financing to increase the amount of equity financing in BUS and UUS and sharia financing can be more competitive than conventional bank loans.

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