

CHAPTER II

THEORITICAL FRAMEWORK AND HYPOTHESIS

2.1 Theories

2.1.1 Islamic Economics System

Islamic economics considers human behavior in completely. It deals with human life as a whole which is consists of multiple mutually-reinforcing sub-systems. The economic sub-system is one of these sub-systems. It is not even the central sub-system. It affects the human behavior only from the border line. The hard core of the system is consists of the basic beliefs in the Unity of God, in the apostle-hood of Muhammad (peace be upon him) and in man's accountability on the Day of Judgement. These beliefs are the foundation of each sub-system (Khan, 1994).

Nowadays, economics system is one of the biggest concern in every country in this world, because from the economics system, they can decide how the country will develop and how they will face the problem that occurs in their countries. The economics system studies are always developing every days because until now, the scholars and researchers still doing their study about economics system to find the best economics system that can bring welfare to all people in the world.

In Islam, the economics system is a little bit different. The main concept of Islamic economics system is the prohibiting of *riba* or usury in the economics system. Islamic economics place human in a good place and really consider about the people welfare by believing that peoples should help each other to make the welfare turn in to reality.

Eradication of poverty, socio-economic justice and equitable distribution of income are among the primary goals of Islam and should be unyielding features of an Islamic economic system (Chapra, 1985). In Islamic economic system itself, alleviating poverty is a big concern, however to apply the Islamic economic system as a whole system is a difficult task to do, the problem regarding poverty still exists recently. Otherwise, the justice and income equality problem have not completely solved. The financial instrument in Islamic finance got some problem as creating new debt to the people, and people could not pay their debt, it keep happens.

Islamic finance as the operational framework of Islamic economics has criticized for its apparent over-reliance on debt-based financial instruments, such as *murabahah* and *ijara* (leasing), it is represent as a consumer-debt industry where the end of result does not contributes to the socio economic and developmental objectives of its founding fathers (Chapra, 1985; Asutay, 2008).

In the investment, Islamic economics system also got their role as a help to people who want to start their business getting their funds and giving place for people who got more money to invest their money in Islamic way. It is a

help for micro-finance and also for the government to increase the national income or to enhance the development of micro-finance.

Islamic micro-finance can be defined as the investment of capital (in cash or in kind) based on Islamic methods of finance to poor entrepreneurs in order to help them start or maintain their businesses (Smolo, 2007). Thus on these basic assumptions Islamic economics has a different position. This provides, in part, need and justification for a separate methodology of Islamic economics. This is not a contention that the process of criticism and rational examination of economic theories itself is questionable. It only means that economics does not have any hard core of sure knowledge which may be treated as a point of reference and criteria for judging the truth and falsity of various theories. Therefore, there is a need for a methodology which not only provides basis for sure knowledge but also eliminates confusion of contradictory theories by laying down a criterion for judging the contending theories. Since mainstream Islamic economics is divine knowledge, it cannot accept a methodology which relies only on human knowledge (Khan, 1987).

With the basic concept of Islamic economics system that was interest-free system, the interest-free system is a must for every economics activity included contracts or product that provided in the Islamic bank.

2.1.2 Islamic Bank

Islamic banking movement show up again coincide with the establishment of the Islamic Development Bank (IDB) in 1974 by the Organization of Islamic Countries (OIC), which has been considered as the starting for the second phase movement (Abdel-Haq, 1989). A large number of Islamic banks were established not only in Muslim countries, but have also start established in non-Muslim countries. Some Islamic banks that established in 1970s are Dubai Islamic Bank (1975), Faisal Islamic Bank of Egypt (1977), Faisal Islamic Bank of Sudan (1977), and Bahrain Islamic Bank (1979) were the first era Islamic bank that established in Muslim countries. The Islamic Finance House in Luxembourg was established in 1978 to represent the first attempt at Islamic banking in Western world (Ariff, 1988), followed by the first Shariah-compliant insurance company (*takaful*) in 1983 in Luxembourg as well (Derbel et al., 2011). Many traditional Western banks have established Islamic windows / branches such the HSBC Bank, ANZ Grindlays, Standard Chartered Bank, Barclays, Citibank, ABN AMBRO, Klienwort Benson, Merrill Lynch, Midland Montagu, and Goldman Sachs (Khan, 2000; Hassan and Ahmed, 2002). Some Islamic countries such as Iran and Sudan have fully Islamized their banking systems during the eighteenth and nineteenth of the previous century (Sundararajan and Errico, 2002).

Islamic financial institutions have taken the form of commercial banks, investment banks, investment and finance companies, insurance companies, and financial service companies. The banking sector, in particular, follows

different banking models, such as private institutions in a conventional economy (as in the most of Arab countries and the West), dual banking models (as in Malaysia), Islamic subsidiaries of conventional banking groups, and Islamic banking windows within conventional banks. With annual growth rates of 15-20% on average over the last five years, the Islamic finance market represents an international segment recording the fastest growth in the finance sector (Derbel et al., 2011). During the last three decades, the number of Islamic financial institutions has risen from one institution in one country in 1975 to over 300 institutions operating in more than 75 countries worldwide (El Qorchi, 2005). These institutions are managing funds of around US\$200 billion, with total assets of more than US\$822 billion (Iqba and Molyneux, 2005; Moin, 2008).

With the basic concept of Islamic economics system, the Islamic bank also apply the interest-free system. It means the interest that usually used in any contract in conventional bank, in Islamic bank is not allowed or it is absolutely prohibited. The interest-free system in Islamic bank is a help for poor people to get the product from the Islamic bank to start or to enhance their economic activities because they don't required to pay additional money from what they get.

The idea of Interest-free banking was introduced in the late of 1940s by Anwar Qureshi (1946), Naiem Siddiqi (1948) and Mahmud Ahmad (1952). The first modern experiment with Islamic banking was established in a small town in Egypt, called Mit Ghamr, in 1963 by Dr. Ahmed El Najjar. The bank

took the form of a saving-investment bank based on profit sharing and free interest, rather than commercial bank (Ariff, 1988; Siddiqi, 2006).

According to Iqbal (1997), the economic development of Islamic countries can be greatly enhanced by the Islamic financial system due to the mobilization of savings that are being kept away from interest-based banks and the development of Islamic capital markets. This motivation to invest in Islamic banks may also stem from the fact that research shows the share in the banks' profit may at time be higher than the fixed rate of interest given by conventional banks.

Even Iqbal and Molyneux (2005) are of the opinion that Islamic banking promotes innovation by financing anyone who has a good idea. If a small and medium entrepreneur has a better project, he has the possibility of getting financed and he will not be held back by the fear of tremendous risk since innovation involves a huge risk. Islamic banking system results in a better risk distribution since the risk is distributed between the financier and the entrepreneur.

Economic development requires effective and efficient mobilization of financial resources both internally and externally and any resource left hoarded indicates unrealized potential for economic development. For Kahf (1999), the focus of Islamic finance on profitability and rate of return of investment due to equity and profit sharing has the potential of directing financial resources to the most productive investment and hence increases the efficiency of resources allocation. However, the adoption some elements of the Islamic financial

system, which are also part of the western heritage, and indispensable for ensuring the health and stability on the global financial system.

Ali (2011) argues even the credit types of Islamic financing, like *murabahah* and *ijara* transactions, which provide credit against usufruct or tangible asset, required Islamic banks to know the client's purpose and the use of finance. These modes also require ownership of the asset by the bank, albeit for shorter duration in case of *murabahah* and longer duration in case of *ijara* finance. This increases the likelihood (or ensures) that the funds are used for their stated purposes. Thus, keeps credit tied to real economic activity for each transaction and throughout the tenor of contract. In conventional bank financing the client is not required to disclose the use of funds as long as the client is believed creditworthy or can post suitable collateral. This ownership of the financed asset by banks can help them in credit risk mitigation. In addition, it curbs the roll-over of the credit which may lead to the ballooning of debt and credit which may delink the financial sector from the real sectors.

It also has been observed for small manufacturers and farmers, as compared with larger production units, face much greater difficulties in obtaining short, medium and long-term credit through institutional channels. The major constraint to access to finance was the lack of tangible collaterals.

Abdouli (1991) argues that Islamic banking breaks this discriminative barrier and offers an equal opportunity to all potential producers by taking intangible assets, such as education, skills, and experience as collateral as tangible assets. Islamic banking would contribute to the emergence of a just

and growing economy by enabling small enterprises to obtain finance on participatory basis in which collateral is not necessary. He argues that the common practice of western banking institutions of granting credit facilities only to those who are able to offer sufficient tangible collateral security, would rather deteriorate the already uneven income distribution between upper and lower classes. Because of the nature of its operations, Islamic banking does offer a new dimension in lending. Since it is a system based on participatory financing, Islamic banking would not depend on tangible collaterals as much as western/conventional banks. Such access of finance not totally dependent on wealth endowment, would eventually lead to a better distribution of income and a larger improvement in the well-being of those who for none of their fault were endowed with niggardly resources.

Moreover, El-Ghattis (2011) argues in contrastly to conventional methods of financing, Islamic financing is not centered only around creditworthiness of the client but rather on the worthiness and profitability of the project to be financed. Therefore recovering the principal becomes a result of profitability and worthiness of the actual project. The Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution, which results into greater benefits for social justice and sustainable growth. The profit and loss sharing (PLS) scheme improves capital allocation efficiency as a return on capital depends on productivity and profitability of the financed project.

The profit and loss sharing based financing encourages entrepreneurial activities by removing the injustice caused by interest-based financing which makes the entrepreneur responsible for every loss happens to his project. PLS distributes risk in a fair manner that encourages venturous entrepreneur to take more projects with the same level of risk-taking attitude he/she already has. For Kahf (1999) entrepreneurship and risk sharing are therefore promoted by Islamic finance and its expansion to the poor members of the society is an effective development tool. The social benefits are clear, as currently the poor are often exploited by financial institutions charging usurious rates. This sharing principle is very different to traditional banking practices. It introduces the concept of sharing to financing and creates a performance incentive within the mind of the banker that relates deposits to their performance in the use of fund. This increases the deposit market and gives it more stability.

2.1.3 Islamic Contracts

Various forms of commercial contract in Islam can be identified in the Qura'n (Ajlouni, 2012). Islamic contracts of relevance to commercial and financial activity are widely recognized as contracts of exchange, contracts of charity and contracts of investment and partnership. According to Ahmed and Zakaria (2011), it is generally agreed, commercial transaction should be concluded at a price that is agreed mutually and not under duress.

Islam generally permits trade and commerce, therefore civil contracts can be used in Islamic banking and finance. Brown (2003), defines the concept

of Islamic banking and finance and mobilization of deposits through contracts by *shariah* and application of funds through contracts permissible by the *shariah*. According to Chachi (2005), the concept of Islamic banking was developed in late 1940s, based on the norms and standards of Sharia law. Islamic financial contracts are the basis for the operations of Islamic banks and it also has the same importance to the conventional banks which offer *shariah* compliant products (Faraq, 2010).

2.1.3.1 Mudharabah

Mudharabah (finance by way of trust) is a form of partnership in which one partner (*rabb al-mal*) finances the project, while the other party (*mudharib*) manages it (Gamal, 2006). According to Gamal, *mudharabah* though similar to *musharakah*, has a financing mode, does not require that a company be created, the financial institution provides all of the capital and the customer is responsible for the management of the project. Profits from the investment are distributed according to a fixed, pre-determined ratio.

Mudharabah is equivalent to equity financing in conventional banking. It is a profit sharing contract that is entered between the Islamic bank and the investor. The bank is the funds owner while the borrower (investor) will be the working partner. The borrower will approach the bank with a trading venture in which they will require a certain amount of investment. The bank therefore provides principle capital into the venture while the borrower takes full charge

of managing this venture for the purpose of maximizing its profit and to liquidate all its properties by its closing date. The bank has the full right to inspect accounts, books and records of the venture at any time and place a reservation on any managerial acts it sees unfit in the best interest of the venture. This input is important since the bank is taking all the risk. The profits are shared at a predetermined ratio whereas any losses made are borne by the bank. Losses incurred due to indiscretions by the borrower will be borne by the borrower and not the bank (Monzer, 1975).

2.1.3.2 *Murabahah*

Monzer (1975) explains that *murabahah* is the equivalent to asset financing in conventional banking. It is a cost plus mark up contract. The parties to this contract are the Islamic bank and the borrower. The borrower will approach the bank to buy an asset on their behalf from a supplier in a predetermined price upfront. The bank will then carry out its own due diligence before agreeing to take up the contract.

Once the contract is approved, the bank will purchase the asset and the borrower will be given a period of time to pay the bank for the asset at a price which will include the asset price plus a markup profit for the bank. This mark up is determined before the asset is bought and the borrower is made aware. The assets can be used as collateral for the transaction or the borrower can provide another form of collateral. The borrower can pay in predetermined installments the whole amount owed (cost plus mark up).

In *murabahah* contract, the bank agrees to buy an asset or goods from a third party, and then resells the goods to its client with a mark-up (Iqbal, 2011). The client purchases the goods against either immediate or deferred payment.

2.1.3.3 *Musharakah*

Musharakah (partnership) which according to Gamal (2006), is often perceived to be the preferred Islamic mode of financing, because it adheres most closely to the principle of profit and loss sharing. Partners contribute capital to a project and share its risks and rewards. Profits are shared between partners on a pre agreed ratio, but losses are shared in exact proportion to the capital invested by each party.

Musharakah is also an example of equity financing. Unlike *mudharabah*, this contract is a joint venture in which the bank and investor share in both the profits and losses from the venture. The parties to this contract are the Islamic bank and the borrower. The borrower approaches the bank to go into partnership with them on a trading activity. The bank provides a certain amount of capital and the borrower also contributes a certain amount of capital. The borrower will assume all managerial responsibilities but unlike in *mudharabah*, the bank has the right to appoint an employee as a representative in the partnership. The profits and/or losses that come about as a result of the partnership are shared according to a predetermined ratio. The borrower will put under full authority of the bank their securities, assets as a guarantee to be

used only in the case of damage caused by neglect or transgression by the second partner (Monzer, 1975).

2.1.3.4 *Ijara*

Ijara(leasing) contract, similar to a conventional lease, is the sale of *manfa'a* (the right to use goods) for a specific period. In Muslim countries, leasing originated as a trading activity and later on became a mode of finance. *ijara* is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee (Hassan & Mervyn, 2009).

Monzer (1975) explains *ijara* as a leasing contract. The bank purchases goods then leases them to the clients for specified rentals for a fixed period of time. Further arrangements could be made if the client wants to purchase the goods. In this contract, Islamic bank is the lessor and bank client is the lessee. The contract outlines are about the description of the asset to be leased, the amount of rentals charged for leasing the asset, the due date of submitting rentals and the whole period of the rent. Lessor is responsible for major maintenance restores leased asset to normal use in case of any deficiency; defect, unless such defect is caused by improper use by the lessee. The lessor is also responsible for insurance on the asset itself. The lessee is responsible for regular operational maintenance and for any defect caused by harsh, and/or abnormal use of the asset. At the end of the rent period, the lessee shall return the leased asset to the lessor. In the case where the lessee is willing to purchase the asset after the rent period lapses, the contract parameters change slightly in

that, in addition to paying rentals monthly, the lessee will also pay a certain amount that will contribute into the total price for the asset. Thus, the lessee will be saving up towards buying the asset. This amount is agreed at the onset of the contract.

2.1.3.5 *Istisna*

Istisna (commissioned manufacture), although similar to *bai bi-thamin ajil* transactions, *istisna* offers greater future structuring possibilities for trading and financing (Mohammad & Melvis, 2015). One party buys the goods and the other party undertakes to manufacture them, according to agreed specifications. Islamic banks frequently use *istisna* to finance construction and manufacturing projects.

Istisna is a contract to manufacture goods, assemble or process them, or build a house or other structure according to the exact specifications and in a fixed timeline. Payments are given when work on property is finished. Financing *istisna* can only be done by two parallel contracts whose subjects are exactly similar: first contract is between the financier and client. The second contract is between the financier and the contractor who actually manufactures the goods. The client approaches the bank to finance the manufacture of an asset. Then, bank approaches contractor to carry out the manufacturing. Bank pays the contractor after delivered of manufactured goods. The full price paid out plus a markup profit are added up and submitted to the client. The client

pays the bank back in installments. The client delivers assets to be held as collateral until full repayment (Monzer, 1975).

2.1.3.6 *Qard Al-hassan*

According to Bank Negara Malaysia concept paper, the definition of *Qard* refers to a contract of lending money by a lender to a borrower where the latter is bound to return an equivalent replacement amount to the lender. Money may include cash, all forms of currency, gold and silver. A *qard* contract is established when the ownership of a sum of money belong to lender is transferred to the borrower which gives effect the borrower to have an obligation to repay the lender in full. The inherent nature of a *qard* contract is the obligation of the borrower to return the money borrowed in full. Terms and conditions of the *qard* contract that have been mutually agreed upon between the contracting parties and consistent with the Shariah must be binding on the contracting parties. *Qard* contract must consist of the following components: (a) contracting parties, comprising lender and borrower; (b) offer (*ijab*) and acceptance (*qabul*); and (c) money.

The parties in a *qard* contract must be a lender and a borrower (collectively referred to as “contracting parties”). The lender must be the owner of the money to be lent to the borrower under the *qard* contract. The contracting parties must be a natural person or a legal entity that must have the legal capacity to enter into the *qard* contract. Any party to the *qard* contract may enter into the contract through an agent (*wakil*). It should recognized through

an offer and acceptance of contracting parties. The offer and acceptance may be expressed orally, in writing or by any other methods which could be evidenced by appropriate documentation or record. Moreover, it should involve a subject matter which is fungible, deliverable and recognised by the Shariah. This refers to money, include cash, all forms of currency, gold and silver. The subject matter in a *qard* contract have to be guaranteed by the borrower to the lender at all times and in all circumstances including against loss or damages.

The *qard* contract shall not result in any form of contractual benefit to the lender merely for lending money. This includes: (a) execution of contracts for sale of assets conditional on the purchaser borrowing money from the seller; (b) pre-agreed periodic rebate (*ibra'*) to the purchaser on the instalment of a deferred selling price which is linked to the *qard* contract from the purchaser to the seller; (c) any form of incentives promised to a lender to enter into a *qard* contract; or (d) *hibah* given by the borrower to the lender in the form of cash, in kind or benefit that is conditional to the *qard* contract. Any rebate (*ibra'*) in settling the full selling price of the sale contract are allowed. Such rebate (*ibra'*) must separate from the *qard* contract. The borrower under a *qard* contract must not give *hibah* to a lender, in the form of cash, in kind or benefit that is conditional to the *qard* contract. The granting of *hibah* by the borrower to the lender is only allowed when it is solely based on the borrower's discretion. The borrower must not disclose, promote or market the indicative rate or prospective payment of *hibah*. The borrower must not use historical information on the payment of *hibah* to promote or market *qard*. A borrower

may disclose historical information on the payment of *hibah* for purpose of market transparency. The general services, facilities or incentives may be charged with a fee (*ujrah*). Examples of such benefit include internet access to e-payment solution, system infrastructure and cash management services. The borrower must be entitled to any benefit or revenue gained from the money borrowed.

Source of money for *qard* contract, the borrower is not obliged to ascertain the source of money provided for the *qard* contract. The borrower may accept the *qard* without any knowledge of the source of such money. When the borrower has the knowledge, the source of the money used for the *qard* is not Shariah compliant, the borrower must not accept such money. Relevant authority may, on the ground of public interest, exempt acceptance of money acquired or generated from Shariah non-compliant activities under specific circumstances.

Sources for micro-financial institutions could be many and varied, but some of the most popular sources of funds for these include *zakat* (*Almsgiving*), *sadaqa* (*Charitable giving*), *awqaf* (*Charitable endowments*) and *qard al-hassan* (*Benevolence loan*) (Obaidullah, 2008). *Qard al-hassan* is a credit that is paid back at the closing stages of the agreed upon load period which the borrower is not engaged in any interest or profit and loss of the loan (Chapra, 1995).

2.1.4 Financial Intermediaries

Financial intermediation is a pervasive feature of all of the world's economies. But, as Allen (2001) observed in his AFA Presidential Address, there is a widespread view that financial intermediaries can be ignored because they have no real effects. They are a veil. They do not affect asset prices or the allocation of resources. As evidence of this view, Allen pointed out that the millennium issue of the *Journal of Finance* contained surveys of asset pricing, continuous time finance, and corporate finance, but did not survey financial intermediation. Here we take the view that the savings-investment process, the workings of capital markets, corporate finance decisions, and consumer portfolio choices could not be understood without studying financial intermediaries.

Boyd and Prescott (1986) assert that financial intermediaries lend to agents whose information set may be different from their own, in particular, would-be borrowers have private information concerning their own credit risk. Although this suggests a clear role for intermediaries, it is not clear that this is a necessary condition.

A financial intermediary obtains funds from lenders and lends them to entrepreneurs. Economists have tried to explain this intermediary role by arguing the financial intermediary has a cost advantage in certain tasks. When such tasks involve unobserved actions by the intermediary or the observation of private information, then, an agency/incentive problem for the intermediary may exist. Any theory which tries to explain the role of intermediaries by an

information cost advantage must net out the costs of providing incentives to the intermediary from any cost savings in producing information. Existing intermediary theories do not make this final step. We now introduce a financial inter-mediary between entrepreneurs and lenders (whom we call depositors from now on), and examine conditions when this intermediary function is viable considering all costs (Diamond, 1984).

A financial intermediary is a risk neutral agent, with personal wealth equal to zero. The intermediary receives funds from depositors to lend to entrepreneurs and is delegated the task of monitoring the outcomes of entrepreneurs' projects on behalf of depositors (Diamond, 1984).

Banks and other financial intermediaries borrow in order to lend. Since the loans offered by banks tend to be longer maturity than the liabilities that fund those loans, the term spread is indicative of the marginal profitability of an extra dollar of loans on intermediaries' balance sheets (Adrian and Shin, 2009).

Dridi and Hasan (2010) also asserted that there was a difference in terms of financial intermediation between Islamic and conventional banking. The central concept in Islamic banking and finance is justice, which is achieved mainly through the sharing of risk. Stakeholders are supposed to share profits and losses because of the prohibition of interest in Islam. While conventional intermediation is largely debt based, and allows for risk transfer, Islamic intermediation, is asset based, meanwhile centers on risk sharing. One key difference between conventional banks and Islamic banks is that the latter's

model does not allow investing in or financing the kind of instruments like bonds, derivatives and toxic assets which have adversely affected their conventional competitors and triggered the global financial crisis.

2.1.5 Financial Risk

Errico and Farahbakhsh (1998) for instance point out that prudential supervision and regulations governing Islamic banks should place a greater emphasis on operational risk and information disclosure. They explain the special risks attached to PLS. For instance, in certain cases Islamic banks cannot mitigate credit risk by demanding collateral from clients, as their relationship is established on the basis of partnership; moreover, they do not have enough control over the management of projects financed in the form of *Mudharabah*.

Khan and Ahmad (2001) claim the sharing Islamic banks' profit or loss with their investment account holders could introduces withdrawal risk. They also argue that different Islamic modes of finance have their own unique risk characteristics due to the various constraints enforced by *Shariá* (Islamic rules). Sundararajan and Errico (2002) suggest the complexities of PLS modes of finance and the risks associated with the non-PLS activities should be taken into account to establish more effective risk management. They also point out various moral hazard issues which occur as a result of the special relationship between Islamic banks and investment account holders.

Obaidullah (2005) argues deposit withdrawal risk may persuade Islamic banks to deviate from traditional *Shariá* financing principles. This occurs when banks pay competitive market returns to investment account holders regardless of the bank's actual performance.

The case where religious factors lead to lower withdrawal risk for investment account holders may influence Islamic banks' lending behavior. It may weaken their incentives for due diligence and loan monitoring, since Islamic banks can transfer credit risk to investment account holders who do not have the same rights as equity holders but share the same risk (Sundararajan and Errico, 2002).

To measure risk, the majority of the empirical banking literature uses accounting-based ratios that are related to credit and/or liquidity risk, and mainly include the ratio of (i) non-performing loans to total loans and (ii) loan-loss provisions to total loans, and (iii) the ratio of risk-weighted assets to total assets (Casu et al., 2006).

2.1.6 Financial Performance

Performance is the description of the achievements of companies in the operational activities related to financial aspects, marketing aspects, aspects of fund raising and distribution, technological aspects, as well as aspects of human resources (Jumingan, 2006).

According to Gitosudarmo and Basri (2002) financial performance is a series of financial activity in a given period that are reported in the financial statements including income statements and balance sheets. Moreover, Sucipto (2003), describe financial performance as the determination of a certain measurement that can be measured the success of an organization or company in generating profits. Meanwhile, financial performance is the description of the company's financial conditions at a given period concerning aspects of fund raising and distribution of funds, which is usually measured by indicators of capital adequacy, liquidity, and profitability (Jumingan, 2006).

According to Mulyadi (2007) financial performance is the determination of periodic operational effectiveness of an organization and its employees based on the objectives, standards and criteria established earlier. A similar opinion was expressed by Sawir (2005) which states that financial performance is a condition that reflects a company's financial situation based on the goals, standards and criteria. Also, according to IAI (2007), the financial performance is the company's ability to manage and control its resources.

The company's performance is a picture of the financial condition of a company that analyzed the financial analysis tool, so it can be known whether the poor financial condition of a company reflects performance in a particular period. It is very important to understand the resources are used optimally in the face of environmental change. Financial performance assessment is one way that can be done by the management in order to meet its obligations to funders and also to achieve the goals set by the company. Performance can be

defined as the achievements of companies in a given period which reflects the level of health of the company (Sukhemi, 2007).

According to Fahmi (2011) financial performance is an analysis done to identify to what extent the company has conducted the rules of financial performance. Financial performance is a measurement for a firm or bank about how good they use the assets and gaining profit. This measurement also used to identify the financial health of the firms or banks. Some factors used for measuring the financial health are the profitability of the firms or banks or in this paper used return on assets (ROA).

Financial performance is an overview of the company's achievements can be interpreted as the results achieved over the various activities that have been performed. Financial performance is an analysis done to identify to what extent the company has been implementing the operational rules (Fahmi, 2012).

Performance in accounting terms is the quantification of effectiveness in the operation of the business during a certain period. The bank's performance in general is an achievement reached by the bank. The financial performance of the bank is the description of the bank's financial condition at a particular period includes aspects of fund raising and distribution of funds. Performance shows something related to the strengths and weaknesses of a company.

From some understanding of the financial performance above, it can be concluded that financial performance is the achievement of the company in a

period which describes the condition of the company's financial health with using indicators of capital adequacy, liquidity and profitability.

2.1.7 Profitability

According to Harahap (2002), the profitability of a company's ability to generate earnings for a certain period. While according to Husni (2011) the internal determinants of banks profitability are normally consisting of factors that are within the control of commercial banks. They are the factors which affect the revenue and the cost of the banks. Some studies classified them into two categories namely the financial statement variables and non-financial variables. The financial statement variables include factors that are directly related to the bank's balance sheet and income statement. Whiles, the non-financial statement variables include factors like the number of branches of a particular bank, location and size of the bank, etc (Haron, 2004).

Rasiah (2010) claims that the use profitability ratios are not influence by changes in price levels. Moreover, Rasiah (2010), presented that banks generate income mostly on their assets and the assets could be termed as income and non-income generating. With regards to commercial banks income, Rasiah (2010) classified into two, namely interest and non-interest income. The interest income consist of rates charge on loans, overdraft and trade finance which the banks offers to customers. Whereas, the non-interest income is consisting of fees, commissions, brokerage charges and returns on investments in subsidiaries and securities. According to Vong et al (2009), the major source

of banks revenue is interest income. It contributes about 80% of commercial banks earnings. The other source of banks revenue includes dividends and gains from dealing in the securities market. There could be also some minor sources of income for instance earnings from trust activities and service charges on deposit accounts; (Vong et al, 2009).

2.1.7.1 Return on Assets (ROA)

Return on assets (ROA) is often used as a tool to measure the rate of returns on total assets after interest expense and taxes, (Brigham, 2001). According to Horne and Wachowicz (2005), “return on assets (ROA) measure the effectiveness in gaining profit from the available assets; the power to gain profit from the investment capital”. Horne and Wachowicz measuring return on assets (ROA) with the formula of net profit after tax divided by total assets.

Riyanto (2001) called the return on assets (ROA) term as *Net Earning Power Ratio (Rate of Return on Investment / RoI)* which defined as the ability of the capital invested in the total net assets to gains profit. The net profit is the net profit after the tax expense.

The high return on assets (ROA) will be good for the company. High value of Return on Assets (ROA) would indicate the company is able to generate profits relatively high value assets. Investors would like invest to a company with high value of Return on Assets (ROA), as companies with high Return on Assets (ROA) which means it is capable of producing high levels of corporate profits (Ang, 2001). Return on Assets (ROA) is a financial ratio used

to measure the degree to which the assets have been used to generate profits. The greater Return on Assets (ROA) indicate better company's performance, because the company has greater rate of return on investment. (Riyanto, 2001).

2.2 Previous Study

The research from Bashir (2003) entitled “Determinants of Profitability in Islamic Banks: Some Evidence from the Middle East” use cross-country panel data, show the profitability of Islamic banks respond positively to the increases in capital and loan ratios. The results revealed larger equity to total asset ratio and larger loan to asset ratio interacted with GDP lead to higher profit margins. These findings were intuitive and consistent with previous studies. They indicate the adequate capital ratios and loan portfolios play an empirical role in explaining the performance of Islamic banks.

The research from Hassan and Bashir (2003) in their ERF paper entitled “Determinants of Islamic Banking Profitability” found the Islamic banks’ profitability respond positively to the increases in capital and respond negatively to loan ratios. The results revealed larger equity to total asset ratio leads to more profit margins. This finding was intuitive and consistent with previous studies. It indicate the adequate capital ratio play a weak empirical role in explaining the performance of Islamic banks. Islamic Banks’ loan portfolio was heavily biased towards short-term trade financing. As such, their loans were low risk and only contribute modestly to the bank profits. Bank regulators might use this as an evidence for prompt supervisory action. Second,

the results indicate the importance of consumer and short-term funding, non-interest earning assets, and overhead in promoting banks' profits. A high CSTF to total asset ratio is shown to lead to the low non-interest margins.

The research from Haron (2004) in his working paper entitled "Determinants of Islamic Bank Profitability", suggest all three sources of funds for Islamic banks were positively related with profitability. These findings explain the more deposits placed by depositors to the bank, the more income is received by the bank. This study also validate the current practices of Islamic banks which use mark-up principles in their financing activities. This was because an application of profit-sharing principles will have an inverse relationship with profitability.

The research from Teng et al (2013) in their dissertation thesis entitled "The Determinants of Islamic Bank Profitability in Malaysia" found the bank size, asset quality, expenses management and money supply were significant determinants to the impact on Islamic banks' profitability. Bank size and money supply were positively related while asset quality and expenses management were negatively related to banks' profitability. However, the determinants such as capital ratio, liquidity, GDP, inflation and competition did not significantly contribute to Islamic banks' profitability in Malaysia.

The research from Gitongu (2014) in his master thesis entitled "The Relationship Between Financing Contracts and Financial Performance of Islamic Banking in Kenya" concluded if Islamic banking had meaningful contribution to profits, in example banks should adopt a larger proportion of

murabahah and musharakah on their financing portfolio. Given the relationship of the model was positive, increasing proportion of financing contracts offered would affect a bank's financial performance positively. Vice versa, a decline would decrease a bank's performance. The moderate relationship (moderate correlation) between financing contracts and financial performance implies there were other factors affect to bank's financial performance and did not only the financing contracts. The study recommended bank's offering *Shariah* compliant financial services should pay key attention to the contracts they offer and capitalize on those with greater yields. This would significantly improve financial performance.

The research from Ahmed (2015) in his master thesis entitled "The effect of Islamic Banking Contracts on The Financial Performance of Islamic Commercial Banks in Kenya" indicated a notable offer of Islamic contracts in the periods of year 2009-2013. The amount of Islamic contracts fluctuated from one year to another through *murabahah* contract as the highest and present steady levels of uptake among customers. Uptake of Islamic contract was based on the nature of the product and extent of compliance with *shariah*. Strong positive correlation coefficients (0.617) was obtained between financial performance and *murabahah*, meanwhile, *tawarruq* (0.0159) and *mudharabah* (0.038) showed a weak positive, however *ijara* showed a moderately weak correlation of 0.397. A variation of 73.6 % on financial performance due to changes in Islamic contracts *murabahah*, *musharakah*, *tawarruq*, *mudharabah* and *ijara* at 95% confidence level was obtained. A strong positive correlation

of 0.858 exists between Islamic contracts and financial performance. A unit increase in the amount of Islamic contracts would lead to an increase in financial performance by coefficient factors 1.442, 0.739, 0.656, 0.56 and 0.114 respectively. The study recommended an uptake of Islamic products by all other banks as a financial innovation in the sector, suitable policy to profile Islamic contracts based on their uptake and the government to ease licensing process for Islamic banking. The study was limited to the few Islamic products available among Islamic commercial banks. Further study should be carried out on the factors affecting uptake of Islamic contracts in Kenya and regulatory procedures and their effect of ease of doing business for Kenya's Islamic banks.

The research from Chowdhury (2015) in his journal entitled "Which is more important in terms of Profitability of Islamic Banks: Bank Specific factors or Macroeconomic factors? An Empirical Study on Malaysian Islamic Banks" got an empirical findings of this study, suggest specific characteristics on bank, in particular, capital adequacy i.e, equity financing has a positive and significant impact on the banks performance. Moreover, operational efficiency such as overhead expenses are negatively related to Islamic bank's profitability. In this case the Islamic banks should increase the portfolio of equity financing rather than the debt financing. It means Islamic banks should increase the partnership contract for example *mudharabah*, *musharakah* contract where risk sharing principle could be established. Islamic banks in Malaysia were ought to reinforce their equity in order to decrease the likelihood of bankruptcy and increase their size to benefit from the economies of scale.

Moreover, banks should improve the management of their loans respect to total assets through better screening and monitoring of credits. Islamic banks should manage their costs efficiently respect to income to get the best return on asset. As we have found that the macroeconomic factors such as inflation and savings to GNI plays an important role in the profitability of Islamic banks. This is why; Islamic banks should also concentrate on the exogenous factors, and earn more profits, afterwards.

The research from Rahaman and Akhter (2015) in his paper entitled “Bank-Specific Factors Influencing Profitability of Islamic Banks in Bangladesh” found bank size and deposit have significant inverse impact on the profits of Islamic banks. However, there was significant positive relationship between capital adequacy and profitability. Loan and expense management, on the other hand, did not seem to have significant impact. This finding indicate improved bank capital contribute to higher bank’s performance and growth. Larger size of the banks cause the banks to be less profitable implying management’s inefficiency to properly utilize the resources. The deposit was seen a liquidity indicator but as a liability. Consequently, it would cause depletion of Islamic banks’ profit as cost of fund it counts more.

The research from Sadr (2015) in his article entitled “Qard Hasan Financing in Islamic Banks” found the facility of *qard al-hassan* contract provides financing multiple-purpose and multi-stage projects and for complementing other instruments in the process of financing by banks make it a versatile tool of finance for Islamic financial institutions. It’s security feature,

as provided by the *sharīah*, make it a desirable quasi-money asset in Islamic banks' portfolios. Data presented for Islamic banks explain continuously use *qarḍ al-hassan*, in different proportions, along with other permissible Islamic financial contracts. In addition, to its unique features as a mode of finance, the *qarḍ al-hassan* contract provides a favorable savings opportunity for the banks. Unlike *wadī'ah* arrangements, *qarḍ* contracts empower banks to acquire the property rights of the deposits and invest them in profitable avenues.

Based on the previous research by many researchers, in this undergraduate thesis, the researcher want to study the influence of Islamic contracts of Islamic bank to the performance of the Islamic bank in Indonesia using Return On Assets (ROA).

2.3 Hypothesis

Based on the theoretical backgrounds, previous research results and research framework this study develop following hypothesis:

H0: The Islamic Bank contracts give positive impact to the return on asset (ROA) of Islamic bank

H1: The Islamic Bank contracts give negative impact to the return on asset (ROA) of Islamic bank

2.4 Research Framework

Figure 1.1 Research Framework

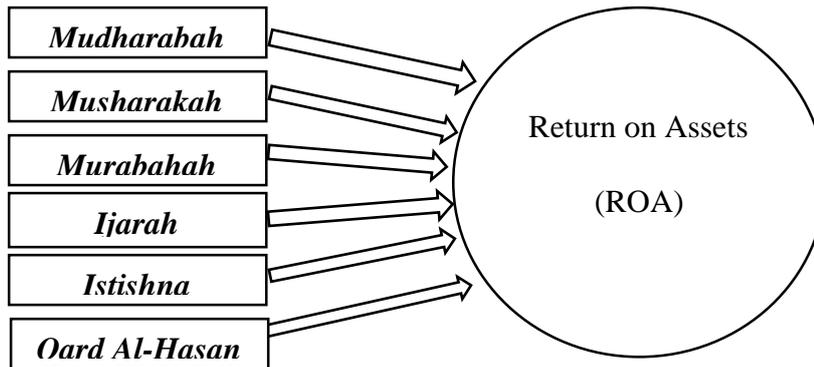


Table 2. 1 Previous Study

No	Title	Results
1	Bashir (2003), “Determinants of Profitability in Islamic Banks: Some Evidence from the Middle East”	Islamic banks’ profitability measures respond positively to the increases in capital and loan ratios
2	Hassan and Bashir (2003), “Determinants of Islamic Banking Profitability”	Islamic banks’ profitability measures respond positively to the increases in capital and negatively to loan ratios.
3	Haron (2004), “Determinants of Islamic Bank Profitability”	All three sources of funds for Islamic banks are positively related with profitability
4	Teng et al (2013), “The Determinants of Islamic Bank Profitability in Malaysia”	As overall, bank size, asset quality, expenses management and money supply are significant determinants to impact on Islamic banks’ profitability.
5	Chowdury (2015), “Which is more important in terms of Profitability of Islamic Banks: Bank Specific factors or Macroeconomic factors? An Empirical Study on Malaysian Islamic Banks”	Capital adequacy i.e equity financing has a positive and significant impact on the banks performance, while operational efficiency such as overhead expenses are negatively related to Islamic bank’s profitability.
6	Rahaman and Akhter (2015), “Bank-Specific Factors Influencing Profitability of Islamic Banks in Bangladesh”	Bank size and deposit have significant inverse impact on the profits of Islamic banks. However, there is significant positive relationship between capital adequacy and profitability. Loan and expense management, on the other hand, do not seem to have significant impact.
7	Gitongu (2014), “The Relationship Between Financing Contracts and Financial Performance of Islamic Banking in Kenya”	If Islamic banking is to have meaningful contribution to profits such banks should adopt a larger proportion of murabahah and musharakah in their financing portfolio.
8	Ahmed (2015), “The effect of Islamic Banking Contracts on The Financial Performance of Islamic Commercial Banks in Kenya”	The amount of Islamic contracts fluctuated from one year to another with murabahah contract being the highest and showing steady levels of uptake among the customers. Uptake of Islamic contract was based on the nature of the product and extent of compliance with shariah.
9	Sadr (2015), “Qard Hasan Financing in Islamic Banks”	<i>Qard al-hassan</i> contract provides a favorable savings opportunity for the banks. <i>Qard al-hassan</i> contracts empower banks to acquire the property rights of the deposits and invest them in profitable avenues

