

CHAPTER I

INTRODUCTION

A. Background

Bank is financial intermediaries between surplus funds with the deficit funds. Banks also become a strategic tool in the economic development. The strategic role due to its mainly functions as a collector and distributor of public funds effectively and efficiently to achieve national development goals. According to Law 10 of 2008 on banking, Bank is a business entity that collects funds from public in the form of savings and distributing the funds to public in the form of credit or other forms in order to improve people's living standard.

Indonesia's banking system is a dual banking system in which banks operate two types of businesses consisting of Islamic banks and conventional banks. According to Law No. 7 of 1992 about Banking which is amended by Law No. 10 of 1998, it says that the commercial banks conduct business in conventional and sharia system.

In Islamic banks, the services provided to customers adapted to Islamic principles in accordance with Islamic law. Sharia principles as applied by Islamic banks is financing based on the principle of profit sharing (*Mudharabah*), financing based on principle of capital participation (*Musharakah*), principle of selling goods to obtain profit (*Murabahah*), or financing of capital goods based on principle of the lease without option (*Ijarah*), or with the option of transfer the ownership of the leased goods from the bank by another party (*Ijarah wa Iqtina*).

According to Antonio (2001), Islamic banks are not tailored with interest rate system. Hence, the profit is derived from profit sharing system with businesses that use the funds of Islamic banks as well as investments of Islamic banks themselves.

Islamic banks are banks without the usury as one of the challenges faced by the Islamic world today. However, the Muslim economists have given a great attention to replace interest rate system in the banking and financial transactions to be more appropriate to Islamic ethics.

Strategic stage in the development of Islamic banking which has been strived is to give permission to the conventional bank to open subsidiaries Islamic Business Unit or the conversion of conventional banks into Islamic banks. This strategic step is a response and initiative of amendments of Banking Law No. 10 of 1998. Law substitute Act No.7 of 1992 clearly stipulates the legal basis and the types of business that can be operated and implemented by Islamic banks.

The emergence of Islamic banks comes to be one of the alternatives to overcome many problems faced by Indonesian economy. Then the development of Islamic banking in Indonesia has become a benchmark for the success of the Islamic economic existence. The monetary crisis that occurred in 1998 have dropped the conventional banks and many banks were liquidated due to the failure of the interest rate system. Meanwhile, banks that implement the sharia system can still exist and survive.

Here is the total amount of BUS, UUS, and BPRS as listed on the Islamic Banking Statistic (SPS) in Indonesia during the observation period:

TABLE 1.1
Islamic Banking Network
Periode 2012-2016

	2012	2013	2014	2015	2016
Islamic Commercial Bank (BUS)	11	11	12	12	12
Islamic Business Unit (UUS)	24	23	22	22	22
Islamic Rural Bank (BPRS)	158	163	163	163	165

Source: SPS OJK 2016

Table 1.1 shows the development of Islamic banking based on OJK's annual report (August 2016). In quantity, the achievement of Islamic banking is really satisfying because of gradual increases in the number of banks. In 1998, there was only one Islamic Commercial Bank and 76 Islamic Rural Banks, then in August 2016s the number of Islamic banks has reached 34 units, consisting of 12 Islamic Commercial Bank and 22 Islamic Business Unit. In addition, the number of Islamic Rural Bank has reached 165 units.

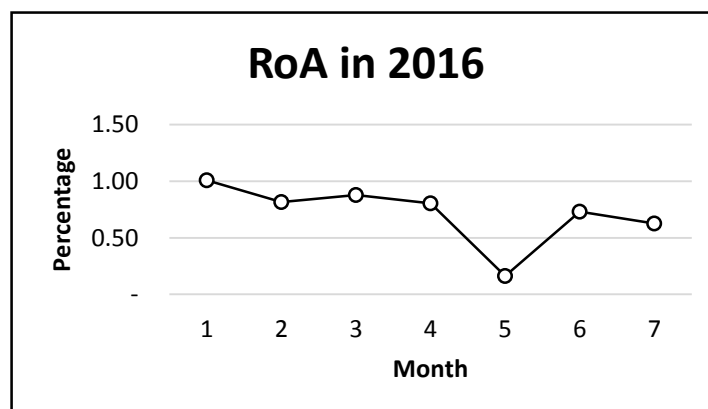
Islamic banks have proved its performance as a financial institution that can survive in the midst of the global crisis. Islamic banks can survive in these conditions sure Islamic banks are still more focused on domestic economic activities, not having a high level of integration with the global financial system. Islamic financial institutions is still stable, profitable, and secure for its stakeholders in Islamic banks.

The growth and the development of Islamic banks could be observed from the results of the assessment of bank performance. In assessing the performance of a bank, an investor usually refers to the prospectus and financial statements of the bank. Because the bank's ability to produce profits and operations is the main focus in the assessment of bank performance, its prospects can be shown in the future. One of the most appropriate indicators to measure the performance of bank depends on the profitability of the bank. The bank's ability to produce profits can be measured by bank's performance. The higher profitability of the bank, the better the bank's performance. However, assessment of financial performance is not enough for the company since it is not only required to focus on improving the condition of financial performance, but also the company is expected to focus on issues related to the development of social relations in the external conditions of the company as the responsibility of the company to the stakeholders and also how well the company in carrying out social responsibility and the environment.

Because the Islamic bank is an intermediary institution that collects funds from the public in the form of savings, current accounts, and deposits, as well as distribute funds to the public in the form of *Murabahah*, *Salam*, *Istishna*, *Ijarah*, *Mudharabah*, *Qardh*, and *Musharakah*, financing is the main function of Islamic banking. Hence it needs special attention, because a good financing can increase the profitability of a bank to improve the bank performance. And then, in the financing disbursing there are many factors that influence both internal and external. Internal factors are factors that come from the bank itself, while external factors are factors that come from outside the banking sector.

On the internal side, to disburse financing, banks must pay attention on specific determinants of the bank and the banks health, because healthy banks have a greater opportunity to perform with good financing, as compared with a bank that is not healthy. To find out whether a bank is healthy or not, it can be measured by financial performance in the financial statements. In assessing the performance of banks, five aspects of evaluation are generally used as homed Capital, Asset Quality, Management, Earnings and Liquidity (CAMEL). These five aspects are assessed using financial ratios. This shows that financial ratios are helpful in assessing the health of the banking conditions, and predicting business survival (Wilopo, 2001).

One indicator to assess the financial performance of a bank is profitability, as measured with Return on Assets (ROA), as the ratio to measure the ability of the bank's management to make a profit.



Source: SPS 2016

FIGURE 1.1.

Return on Assets (ROA) of Islamic Bank in Indonesia

Based on the graph above, the performance of Indonesian Islamic bank can be seen from the Return on Assets (ROA). The performance from January until July keeps decreasing, and it decreases from April to May, and increases again from May to June. In this case, Return on Assets (ROA) of the Islamic bank in Indonesia does not seem to show any good result. According to the previous research from Hasan and Bashir (2003), the Islamic banks profitability measures respond positively to the increases in capital and loan ratios. The greater the ROA of a bank, the greater the level of profit it achieves. Profitability is affected by macroeconomic variables and internal sector from Islamic bank itself.

In terms of external Islamic Bank as a financial institution whose growth can be affected by macroeconomic conditions such as inflation and the exchange rates. In general, these indicators are very influential on the clients ability to raise third-party funds in the Islamic banking industry. These macroeconomic conditions would affect the bank intermediation function, namely financing contract.

In many literatures, inflation is defined as a continuous price increase of an economy which is one of the problems faced by every country. For the business world, inflation can be beneficial for the producers if the income is higher than the increase in production costs. Thus, producers will be encouraged to double its production.

However, when inflation lead to increased production costs and eventually detrimental to the producers, the producers are reluctant to continue production. Producers could stop production for a while, even if not able to keep pace inflation, the producer may experience loss of business, so it will have negative impact on financial performance.

The impact of further inflation would lead to high risk of default. This risk will lead to an increase in Non Performing Financing (NPF) on Islamic banking. If financing is based on profit-loss sharing contract so that will incur losses in the business then this loss also borne by Islamic banks. If the type of financing is the sales contract (*Murabahah*), then inflation can make Islamic financing products in general become more expensive (Saekhu, 2015).

Exchange rate also affects the performance of the financing contract. The exchange rate is the relative price of a country's currency against another country or a country's currency expressed in another country's currency. The exchange rate as created by the market forces will change each of the two components of currency changes. A currency will tend to become more valuable when the demand is greater than the supply itself. The exchange rate will be weakened when demand is less than supply (Krugman, 2000).

Based on the problems above as well as previous studies, this study is important and interesting to be investigated further. This study will be titled as **“Analysis of the Impact of Bank Specific Determinants and Macroeconomic Indicators on Profitability in Islamic Banks Periode 2012-2015”**.

B. Limitations of the Study

There are a lot of factors that may influence performance in Islamic banks. Thus study attempts to restrict the analysis that may occur. Therefore, this study is restricted to following limitations:

1. Only focusing on Islamic banks in Indonesia during research period.
2. Only examining bank specific determinants (financing growth from *Mudharabah, Musyarakah, Ijarah, Istishna, Salam, and Murabahah*), inflation, exchange rate, toward profitability (ROA) in Islamic commercial banks.
3. The study period is ranging from January 2012 – December 2015.

C. Problem Statements of the Study

Based on the background, then the problems we need to solve in this paper include:

1. How does financing growth affect on the profitability of Islamic banking as measured with ROA?
2. How does inflation affect on the profitability of Islamic banking as measured with ROA?
3. How does exchange rate affect on the profitability of Islamic banking as measured with ROA?

D. Objectives of the Study

Based on the description of the background and the formulation of the problems, the objectives of this study are:

1. To determine the effect of financing contracts on the profitability of Islamic banking as measured with ROA.
2. To determine the effect of inflation on the profitability of Islamic banking as measured with ROA.
3. To determine the effect of exchange rate on the profitability of Islamic banking as measured with ROA.

E. Benefits of the Study

The result of this study is expected to provide benefits to related parties, such as:

1. It can help explaining the impact of specific determinants and macroeconomic variables toward performances in Islamic banks.
2. It is expected to give suggestion for the banker to have deep understanding in financial determinants which influence profitability and performance in Islamic banks.
3. It is expected to be references for other researchers.