

CHAPTER II

LITERATURE REVIEW

A. Theories

1. Islamic Banks.

There have been many Islamic countries developing the Islamic banking system other than Indonesia. Discussion on Islamic bank as the economic pillar in Islam appeared in the beginning of the 1970s. In 1970s-1980s was known as the initial period of rise in Islamic banking especially for trade finance and working capital that are still adopted from working mechanism in the conventional banks.

According to the Islamic Banking Act 21 of 2008, Islamic banks are defined as: "banks that are running their business based on Sharia principles consisting of Islamic Banks and Islamic Rural Bank Financing".

The Islamic principles under Article 1 Verse 13 of Law No.10 of 1998 on banking state that:

"The rules of agreement are based on Islamic law between the bank and other parties to deposit funds or financing business activities, or other activities stated in accordance with sharia, among others, financing based on the principle of profit sharing (*Mudharabah*), financing based on the principle of equity (*Musharakah*), principle of trading goods with a profit (*Murabahah*), or the financing of

capital goods based on the principle of the lease without option (*Ijarah*), or with the option of transfer of ownership of goods leased from the bank by another party (*Ijara wa Iqtina*)."

In other words, Islamic Banks are banks that have operational and products which developed based on the *Qur'an* and the *Hadith* of Prophet and did not use interest. Islamic Banks are the financial institutions which provide financing and other services, they operate by adapting the principles of Islamic laws. One of Islamic law foundations about Islamic banks in Surah an-Nisa verse 29:

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْتَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِّنْكُمْ ۝ وَلَا قَتْلُوا
أَنفُسَكُمْ إِنَّ اللَّهَ كَانَ بِكُمْ رَحِيمًا

O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful.

In this sense, it could be interpreted that the Islamic banks in performing their duties must not deviate from the teachings of Islam but they should be help others to create a well-being. We know a lot of economic actions that are inconsistent with the teachings of Islam because some people are not affected by the higher profit or return they get in the conventional system. In order to prevent the condition that inconsistent with Islamic teaching, Islamic bank provides and fortifies people with products which are not allowed in shariah.

The emergence of Islamic bank, as one entity in the financial sector, is certainly related to banking regulation as a legal basis in running its business. The presence of the first Islamic bank in Indonesia was pioneered by the establishment of Bank Muamalat in 1991 and it started full operation in 1992. In this period, the Government has issued Law No. 7 of 1992 on Banking, which introduced a profit-sharing system. In Article 6 letter (m) and article 13 (c) stated that one of the businesses of commercial banks and rural banks provide financing for customers based on the principle of profit sharing. This provision marks the beginning of dual banking system era in Indonesia namely the operation of commercial banking system and banking system with the principles of sharing.

Furthermore, the government has increasingly shown commitments to support Islamic financial institutions by amending the Law No.7 of 1992 as Law No.10 of 1998 which was passed on 10 November 1998 on the government to give firmness to the existence of Islamic banking in Indonesia. The amendment provides provisions regarding to the permissibility of conventional banks to conduct business activities based on Islamic principles through the opening of Islamic Business Unit.

The development rate of Islamic finance industry grows rapidly and begins to organize which consist of banking, leasing company, capital markets, insurance, and others with a wide range of financial products that are free of interest between 1980s-2000s which known as the renaissance period.

In 2000-2010, the Islamic finance industry has been able to offer more sophisticated products and compete with conventional products, it can be said that Islamic finance has become a full industrial value added. As an intermediary institution, these developments have encouraged Islamic finance industry more efficient and productive, so that the Islamic finance industry is recognized globally as a genuine alternative to the modern financial system at this time.

2. Islamic Bank Finance.

Credit is the provision of money or bills which can be equated with it, based on agreements between bank lending and other parties who require the borrower to pay the debt off after a certain period of time with interest. While financing is the provision of money or bills can be equated with it, based on agreements between the bank and other parties who require the financed party to return the money or the charges after a certain period of time in exchange or sharing system (Banking Law No. 10 of 1998).

According to the explanation above, the credit or financing in the form of bills has value which measured by money for example the bank will pay credit for house purchase. It is after an agreement that being made between banks as creditors, with customers credit recipients as debtors.

Later on, in the credit agreement, the rights and obligations of each party involved have been listed, including the period and interest set together and established penalties to be awarded if one of the two parties does not obey the agreements that have been made together. So, there is difference between the credits provided by the conventional banks and provided by the Islamic Bank financing. For conventional banks profits will be obtained through the interest, while Islamic banks gain profit from profit sharing.

3. Islamic Banking Products and Services.

The types of financing that is often used in the distribution of funds of Islamic banks in general are as follows:

1) Mudharabah Financing

Mudharabah is derived from the word *Dharb* which means to hit or run. The more precise meaning is the process of someone hit his legs in running the business (Heykal 2010). *Mudharabah* is a contract of cooperation undertaken between *shahibul maal* (owner of the funds) and *mudharib* (the fund manager) with profit sharing ratio under the previous agreements. If the business carried on a loss, the entire loss will be borne by the owner of the funds, unless there is negligence by the management of funds, such as the diversion and abuse of capital according to the agreement (Muhammad 2005).

2) Murabahah Financing

Etymologically, *Murabahah* is derived from the word *al-ribh* which means excess, the increase in trade (النَّمَاءُ فِي النَّجْرِ). In other words, *al-ribh* can be interpreted as profit and avail.

While the term *Murabahah* is a contract of sale on certain goods, the seller mention the selling price consists of the cost of goods and a certain profit level for the goods, the buyer agreed to sell price (Hakim 2012). According to Antonio (2001), *Murabahah* sell at the original price agreed with the additional advantage. In *Murabahah* trade, the seller must notify the price of products purchased and determining a level of profit as an extra. Meanwhile, *Murabahah* transaction is a trading at the initial price plus a certain profit (Zuhaili 1997).

3) Musyarakah Financing

Musyarakah or *syirkah* in etimolog means combining someones property with the property of others, so it is not possible to distinguish (Suhendi 2010) . *Musyarakah* is a partnership contract between two or more parties to a particular business in which each party contributes funds to the agreement that the benefits and risks will be shared in accordance with the agreement (Ascarya 2008).

In other sense, according to the Islamic Financial Institutions, *Musyarakah* is a partnership contract between Islamic banks and customers. Islamic banks agreed to finance the business together with the customer as the initiator of the project on the basis of profit sharing of the results obtained from the business based on the percentage profit sharing system that has been set in advance (Lubis 2001).

4) Ijarah Financing

The word *Ijarah* etymologically is derived from the word *al-Ajru* that means is *al-iwadh*, the meaning in the Indonesian is replacement and wages. Meanwhile, according to Syafi'i (2004) *Ijarah* is بيع المفعة or sell the benefits.

According to al-Jaziri (2004), the concept of wages appearing in *Ijarah* contract is the ownership of services, from *ajir* (people who contracted power) by *musta'jur* (people who contracted *a'jur*). *Ijarah* is a transaction to certain services along with compensation.

Based on the above understanding, it can be concluded that there are three main elements in *Ijarah*: firstly, an element of the parties that made the transaction, ie employers and workers. Secondly, elements of the contracts, ie *ijab* and *qabul*. And thirdly, the material elements of the agreement in the form of work and *ujrah* or wages.

Distribution of wage to the workforce, it can be classified into two forms of payment, namely salaries and wages. Salary is in return for payment to the workers permanent and professional workers. Salary payments are generally conducted once a month. While the wages as payment to workers whose jobs are always moving (Sukirno 2000).

5) Istishna Financing

Istishna is sales contract between *mustashni* (buyer) and *shani* receives orders from *mustashni* to make the desired item. Word *istishna* derived from the word *shana'a* meaning making. Then added the letter *alief, sin* and *ta'* into *istishna'*, it means the request to made something.

Istishna' is sales contract between *mustashni* (buyer) and *shani* (maker of the goods) or seller in this contract *shani* received orders from *mustashni*, *shani* then attempted his own or through others to make goods (*Manshu'*) in accordance with the agreed specifications and sell it to *mustashni*, the two parties agreed on an agreed price and payment systems. So, *istishna* is a sale contract of goods which the buyer ordered goods with predetermined specifications previously with payments made before the goods are completed, either in cash or installment and delivery of goods carried on the agreed time in the future (Setiana 2008).

6) Salam Financing

Salam in term of *fiqh* is also called *as-Salaf*.

Etymologically, these two words have the same meaning, namely prioritizing payments and end goods. The use of the word *salam* usually used by Hijaz people, while the use of the word *as-Salaf* normally used by the Iraq people.

In terminological, *salam* is selling goods the delivery of which was delayed, or sell an item whose characteristics are clearly stated with a capital payment in advance, while the goods are delivered in the future (Hasan 2003). According to Sabiq (1988), *as-salam* or *as-Salaf* is selling something with specific criteria (which still is) the dependents with payment immediately or expedited.

From the definitions above, it can be concluded that the *salam* contract is sales transaction for which payment carried out when the contract underway and delivery of goods carried out in the end in accordance with the agreement that has been agreed by the seller and the buyer.

4. Theory of Economic Stability.

Macroeconomic stability is a fundamental factor to ensure sustainable economic growth and as a basic prerequisite to achieve improvements in public welfare through higher growth and improving the quality of growth.

Those efforts to maintain macroeconomic stability are carried through steps to strengthen the resilience of the domestic economy to the various problems that arise, either from within or from outside the country. They can give the importance of macroeconomic stability for the success of national development goals. Government is determined to continue create and consolidate macroeconomic stability. The efforts are also accompanied by a program of development activities which in practice are required to include several strategies to control inflation, exchange rate stability and low interest rates.

To improve the performance and sustainability of the financial sector as well as development funding sources, financial sector policy is focused on efforts to maintain the resilience of the financial services industry, the increase in the intermediation function of public funds, and development of safety net systems in the financial sector. As a financial institution which has the function of financial intermediation the largest in Indonesia, national banks are directed to be more instrumental in encouraging development in various sectors of the loan portfolio which are more equitable throughout the country, as well as affordable by all economic actors, especially small micro medium enterprises. It needed the macroeconomic analysis to analyze the external factors, such as events that happened in the outside of the company, it cannot be controlled directly by the company.

Macroeconomic environment will affect the company's operations in making policy decisions that related to the financial performance of banks. Factors that influence the decision of management in banking are internal factors and external factors. The internal factors may be associated with the policy and strategy of the bank's operations. While external factors (factors that come from outside the company) include monetary policy, exchange rate fluctuations, and inflation rates, interest rate volatility, and innovation of financial instruments (Siamat 2005).

1) Inflation Rate

One of the modern events which is always found in almost every country in the world is inflation. If inflation takes place in the long term and is at a high level, it will be a serious economic problem. Theoretically, inflation is rising on prices of goods in general and continuously. So, it cannot be said as inflation when the increase occurred only in a small group of goods and price changes that occur only once (Yuliadi 2008).

Bank Indonesia defines inflation as rising prices in general and continuously. It not be called inflation if prices of one or two items only, otherwise lead to increasing the price on other goods. The opposite of inflation is called deflation.

Consumer Price Index (CPI) is an indicator that is often used to measure the rate of inflation. While inflation according to the causes, can be divided into two kinds. They are:

a. Demand Pull Inflation

Demand-pull inflation caused by the public demand for goods (aggregate demand) increases. Inflation usually occurs during the fast growing economy. Because the need of job opportunities is high, it will create high levels of income and expenditure raises that exceed the economic capacity of issuing goods and services. Excessive spending will cause inflation. So, the government is forced to print money or borrow from the central bank to finance such overspending that causes aggregate demand. It will exceed the ability of the economy to provide goods and services. Then, this situation will lead to inflation.

b. Cost Push Inflation

Cost Push Inflation occurs because of rising production costs caused by the depreciation of the exchange rate, the impact of foreign inflation, the increase in commodity prices regulated by the government (administered price), and the occurrence of negative supply shocks caused by natural disasters and the disruption of distribution.

Inflation usually occurs when the rapidly growing economic period, and the unemployment rate is very low. If the company still faces increasing demand, then it will try to raise production by providing higher salaries to their employees and look for new workers to offer higher payouts. This move leads to increased production costs, which ultimately will lead to rising the prices of various goods.

2) Exchange Rate

Hanafi (2009) defines the exchange rate as the value of a currency relative to other currencies. For example, the exchange rate IDR / USD (Indonesian rupiah against the US dollar) that has a value of IDR 10,000/\$. The exchange rate means that one US dollar is equal to 10,000 Indonesian rupiah. The absolute value of the exchange rate may not be so important. In other words, in the above exchange rates for example, does not mean that the rupiah currency is worse because it is cheaper than the United States dollar.

In fact, changes in the exchange rate are more important to note. If the rupiah has a tendency to weaken against the US dollar, the likelihood may indicate something happened. The currency of a country is a reflection of the economic conditions of the country concerned.

If the economy of a country improves, the country's currency tends to strengthen against other currencies. Conversely, if a country's currency weakened against the currencies of other countries, it is possible that the condition of the country weakened compared to the previous.

Exchange rate based on market forces will continue to change at any time the value of one of the two components of currency changes. A currency will tend to become more valuable when demand is greater than the provided supply. Instead, the value will be reduced if demand is less than the provided supply. Increased demand for the currency is good news because of the increased demand for transaction money, or perhaps an increase in speculative demand for money.

5. Theory of Performance Bank.

According to Fahmi (2011), the financial performance is an analysis done to see the extent to which a company has implemented the rules of financial performance is good and right. The company's performance is a picture of a company's financial condition which is analyzed by using the tools of financial analysis. So, it can be known about the good and bad financial condition of a company that reflects performance in a particular period. It is very important that resources are used optimally in the face of environmental change.

As a financial institution, the role of banks is quite pivotal in economy. The health of banks is very important to gain the trust of people. Healthy banking system will be able to perform the duties as well financial institutions which collect funds from public in the form of savings and distribute them to provide credit or loans.

Banking performance measurement is an activity that is intended to assess the success of the management of a bank. The financial performance is periodical determination of financial views based on the goals, standards, and performance preset. A measure of financial performance is used to determine the excellence of performance and financial analysis because of financial analysis involves the financial assessment in the future.

The assessment purpose of banking performance by Munawir (2000) is as follows:

- 1) To determine the level of liquidity, ie the ability of banks to fulfill its finances when billed or to obtain a financial obligation that must be met.
- 2) To determine the level of solvency, ie the ability of a company to fulfill its financial obligations, if the company is liquidated, either short-term or financial liabilities and long term.
- 3) To determine the level of profitability, which indicates the company ability to produce profits for certain period.

- 4) To determine the level of business stability, ie the ability of the company to do business steadily, as measured by considering the company's ability to pay interest charges on debts without experiencing delays or of the financial crisis.

The growth and development of Islamic banks could be seen from the results of the assessment of bank performance. In assessing the performance of a bank, an investor usually refer to the prospectus and financial statements of the bank. Because the bank's ability to produce profits and operations are the main focus in the assessment of the performance of a bank, and the bank may indicate the prospects in the future. One of the most appropriate indicators to measure the performance of a bank is dependent on the profitability of the bank. The bank's ability to produce profits can be measured by the performance of the bank.

Bank's profitability can be seen from a wide variety of ratios, such as Return on Assets (ROA), Return on Equity (ROE), Net Profit Margin (NPM), and the ratio of Operating Costs (Dendawijaya 2003). According to Syofyan (2003) the measures of profitability appropriate in assessing the performance of the banking industry is ROA. ROA is used to measure the ability of the bank's management to make a profit overall. The greater the ROA of a bank, the greater the level of profit achieved by the bank, and the better the position of the bank in terms of asset utilization.

According to Sawir (2005), Return on Assets (ROA) is a ratio used to measure the ability of the management company in obtaining the overall advantage. The larger the ROA of a company, the greater the level of profit achieved by the company and the better the company's position in terms of the use of assets.

B. PREVIOUS STUDY

Many types of research have been conducted on the factors that affecting the profitability in Islamic banking finance. Each research has its own variables combination, the methodology of research, and results which can differentiate with other researches. The previous researchers are:

A research held by Pratama (2015), it stated that there some impacts of macroeconomic variables on the performance of Indonesian Islamic banking. The objective of this research is Indonesian Islamic Banking. The method of analysis is Vector Autoregressive (VAR) / Vector Error correction model (VECM). The results of this research show that based on the variance decomposition, shocks in macroeconomic variables only gives little effect to the performance of Islamic banking. Based on the analysis of IRF, the influence of macroeconomic variables to the performance of Islamic banking is stable in the long-term and shocks to fluctuations in the short-term.

Assegaf, Putri dan Syarief (2014), the research is about the impact of macroeconomic variables on the financial performance of Islamic banks in Indonesia. The independent variables in this research are macroeconomic variables (inflation, interest rate, and money supply). The method in this research is multiple linear regression analysis. The results of this research are firstly, simultaneously all of the macroeconomic variables and ROA in the previous month significantly influence the ROA of Islamic banks. And partially all of the macroeconomics variables except ROA on the previous month not influence the ROA of Islamic banks. Secondly, simultaneously all of macroeconomic variables and ROE on the previous month significantly influence the ROE of Islamic banks. And partially, only BI Rate had not significant effect to the ROE of Islamic banks. Thirdly, simultaneously all of the macroeconomic variables and NPF on the previous month significantly influence the NPF of Islamic banks. And partially, only BI Rate had not significant effect to the NPF of Islamic banks.

According to Sen, et al. (2015), there are some factors that affects performance of Islamic banks and conventional banks in Malaysia. The method in this research is descriptive methods with a simple regression analysis. The result of this research is the influence of capital adequacy, operational efficiency, economic growth and inflation to the profitability of conventional banks is significant and will not necessary affect the profitability of the conventional bank.

Fadjar, Esti and Prihatini (2013) state that there are some internal factors and external factors that influence the performance of Islamic commercial banks in Indonesia. The method in this research uses multiple linear regression analysis. The results of this research are all of the variables have positive significant influence to the ROA, then internal factors significantly influence to ROA general bank, while external factors of banks and CAR do not significantly influence to the ROA of the general bank.

Research of Dwijayanthi dan Naomi (2009) is about the impact of inflation, BI rate, and exchange rate on Bank Profitability. The method of this research is multiple regressions. The result of this research is BI rate had no significant relationship with bank profitability because there was the negative relationship between exchange rate, inflation and bank profitability.

Research of Ghazali (2008) is about the influence of bank specific characteristics and macroeconomic conditions on Islamic bank profits during 2002 to 2007 period are taken. The data are taken from Bank Scope database. The research employs regression models. The results from this research are any positively significant relationship between profitability measures of Islamic banks and macroeconomic variables such as GDP growth and inflation, and the main determinants of Islamic banks profit are capital strength and efficiency factors, although the latter is negatively correlated to profitability.

Chalifah and Sodiq (2015) state that there is an effect of *Mudharabah* and *Musharakah* on profitability Bank Syariah Mandiri. The purpose of this research is to analyze the impact of *Musyarakah* and *Mudharabah* to the level of profitability (ROA) of Bank Syariah Mandiri simultaneously or partially. The method in this research is using multiple linear regression analysis. The results of this research, first, from t-test value, *Mudharabah* have a positive and significant effect on ROA, meanwhile *Musyarakah* has significant negative effect on ROA. Second, from F test value, *Mudharabah* and *Musyarakah* have a positive significant effect on ROA.

Fadholi (2015) states that there is an effect of *Murabahah*, *Musyarakah*, and *Mudharabah* on Islamic Commercial Banks Profitability by using Return on Assets (ROA) ratio. The method of this research is quantitative descriptive method and multiple linear regression analysis. The data are taken from secondary data of financial reports in Islamic Commercial Bank such as BRI Syariah, Bank Syariah Mandiri, BNI Syariah, Bank Panin Syariah and Bank Muamalat within period 2011-2014. The results of this research are *Musyarakah* and *Murabahah* have significant effect to ROA, and partially *Mudharabah* has a positive and significant effect to ROA. And simultaneously, *Murabahah*, *Musyarakah*, and *Mudharabah* have significant effect to ROA.

C. THEORETICAL FRAMEWORK

1. The Influence of Financing Growth on Profitability in Islamic Banks.

Financing is providing facilities for the provision of funds, to fulfill the needs of the parties who are deficit units (Antonio, 2001).

Research conducted by Fadholi (2015) indicates that *Musyarakah* and *Murabahah* have significant effect to ROA, and partially *Mudharabah* has a positive and significant effect to ROA. And simultaneously, *Murabahah*, *Musyarakah*, and *Mudharabah* have significant effect to ROA. Then, the research conducted by Amalia (2016) indicates that *Murabahah*, *Istishna*, *Mudharabah*, *Musyarakah* financing have an influence to the profitability on the banks. Meanwhile, the *Ijarah* financing does not have any influence on the profitability of Bank Muamalat Indonesia and Bank Syariah Mandiri.

Therefore, the researcher predicts that financing contracts will affect profitability (ROA) in Islamic Banks in Indonesia.

2. The influence of Inflation on Profitability in Islamic Banks.

Inflation is a condition that shows the general price increases steadily from an economy. It is one of the problems faced by each country. For the business world, as producers of goods and services, inflation can be beneficial if the income is higher than the increase of production costs.

A research conducted by Aris Munandar (2014) indicates a significant relationship between interest rates and inflation on the profitability of Islamic banking. Inflation on the profitability of Islamic banking has a positive effects, it means that if there is an increase in the rate of inflation, the profitability of Islamic banking is also increased. Interest rate and inflation simultaneously have a significant effect on the profitability of Islamic banking.

Empirically, a lot of researches, with different background of the sample, which have proven that inflation has an influence on ROA. It is expressed by Dwijayanthi (2009) and Wibowo (2013) that there are significant partially or simultaneously between the variables of inflation to ROA.

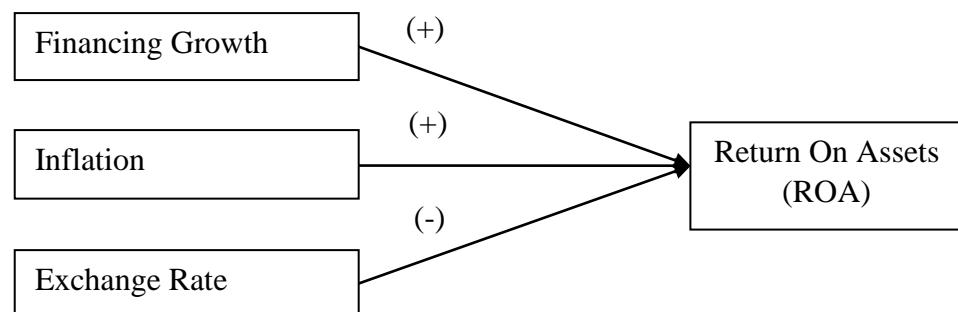
Therefore, the researcher predicts that inflation will affect profitability (ROA) in Islamic Banks in Indonesia.

3. The influence of Exchange Rate on Profitability in Islamic Banks.

The exchange rate is not able to push the company's performance to be better if the exchange rate cannot increase the company's profitability. Exchange rates will be very dangerous in case of depreciation of the exchange rate, because it will burden the company, with the low level of profit (Prasetyantoko 2008).

A research conducted by Hidayati (2014) indicates that the variable exchange rate has significant impact on the profitability of Islamic banks. The influence of exchange rate on bank profitability identifies if the exchange rate appreciation or depreciation, it will have an impact on bank profitability. The strengthening of the rupiah exchange rate against the US dollar will increase the profitability of Islamic banks.

Therefore, the researcher predicts that exchange rate will affect profitability (ROA) in Islamic Banks in Indonesia.



D. Hypothesis

Based on the observation, the theories, and the previous studies, so the researcher adduces hypothesis:

H1: Financing growth had a positive and significant effect on the profitability of Islamic banks.

H2: Inflation had a positive and significant effect on the profitability of Islamic banks.

H3: Exchange rates had a negative and significant effect on the profitability of Islamic banks.