CHAPTER II

LITERATURE REVIEW

A. Theoretical Basis

1. Islamic Bank

Based on *Undang-Undang No. 21 Tahun 2008 pasal 1,* Islamic bank is a bank which runs their business activity based on Sharia principles and based on its types consist of Islamic Commercial Banks and Islamic Rural Banks. Islamic bank can also be defined as a financial institution which functions to give financing or other services in transactions and supplying money which operates based on Sharia principles (Sudarsono, 2008). In other terms, Islamic bank is a bank which operates based on Sharia principles, especially in the procedures of *muamalah* (Perwaatmadja and Antonio, 1999).

By looking at the definition of Islamic bank itself, the purpose and function of Islamic bank are in line with Sharia principles, those are: the equitable of economic prosperity, full work time rate, optimum growth of economics, socio-economics equity and income distribution equity, the stability of money, the mobilization and the investment of deposit which guarantee the fairness on payback and effective services (Setiawan, 2006).

At the present time, Indonesia has a progressive Islamic banking industry which directly involves in real sector. There are at least four engines of growth which boost the development of the Islamic bank in Indonesia. The first is the high population of Muslim in Indonesia, there is at least 208 million Muslim people out of 237 million populations which mean the number of customer will boost the development of Islamic banking industry in Indonesia. The second is the support from the banking regulators, parliament, government, and Sharia scholars which successfully provided underlying acts to make Islamic banking operates better, such as the establishment of the financing scheme. The third is the robust performance itself which has attracted public to deposit and become the business partners, even though the support from the public is counted as a rational one, such as the competitive return. The fourth is the performance of the Indonesian economy backs up business operations of Islamic banks (Ismail, 2011). The development of Islamic banking industry in Indonesia within the last five years will be shown below:

Table 2.1 Islamic Banking Network

Indicator	Dec 2012	Dec 2013	Dec 2014	Dec 2105	Oct 2016
Islamic Commercial Banks					
Number of Banks	11	11	12	12	13
Number of Office	1.401	1.745	2.151	1.990	1.885
Islamic Business Units					
Number of conventional banks that have Islamic busines unit	24	23	22	22	21
Number of Offices	517	590	320	311	318
Islamic Rural Banks					
Number of Banks	158	163	163	163	164
Number of Offices	401	402	439	446	451

Source : Statistic of Islamic Banking in Indonesia period of 2012-2016

Based on table 2.1, the development of Islamic banks from many indicators can be seen. From Islamic Commercial Banks indicator, the number of banks is having no changes within the period of 2011-2013, but it increases from 11 banks to 12 banks at the end of 2014. From Islamic Business Unit indicator, the number of banks decreases within the last five years, from 24 banks at the end of 2011 to 22 banks at the end of 2014. And from Islamic Rural Banks indicator, the number of banks fluctuates within the last five years, it increases from 155 banks at the end of 2011 to 161 banks at the end of 2014, and it decreases to 161 banks at the middle of 2015.

In spite of the fact that the Islamic banking industry in Indonesia shows a remarkable performance, it still has some challenges to be solved. The first challenge is the market share which limits the expansion of this industry. The second is lack of human resources due to the fact that the growth of Islamic banking is not followed with many well-Sharia educated employees. The third is the lack of product development (Ismail, 2011).

2. Islamic Commercial Bank

Based on *Undang-Undang Nomor 21, Pasal 1 Tahun 2008,* Islamic Commercial Bank is an Islamic banking which provides transaction services in its activity. A bank can be categorized as Islamic Commercial Bank if its whole structure of bank organization is based on Islamic principles, either from the central office to the service office or the whole entity itself have to base on Islamic principles (Wiroso, 2011).

There are at least three requirements for the establishment of Islamic Commercial Banks, such as (Kusnanto,2011):

- Minimum paid-up capital isRp 1 trillion. It goes the same for foreign bank which open Sharia branch office
- The source of paid-up capital for the establishment of Islamic Commercial Banks is not a loan from other banks or parties in Indonesia
- The source of paid-up capital for the establishment of Islamic Commercial Banks is not from the prohibited source based on Sharia principles.

3. Islamic Business Unit

Islamic Business Unit is a work unit of central office, Conventional Commercial Bank, which acts as main office of offices or units which enforce banking activity based on Sharia principles, or a work unit in branch office of a foreign bank which enforce their banking activity conventionally which acts as main office of branch offices and or Islamic units. Simply said, Islamic Business Unit is a conventional commercial bank which has Islamic business. The establishment of Islamic Business Unit must be permitted by Bank Indonesia. Its minimum paid-up capital requirement is Rp 100 Billion.

The Sharia aspects on Islamic Business Unit are still debated among the experts. It is because of the capital of Islamic Business Unit is from the income of conventional bank, which comes largely from interest, while interest itself is prohibited in Sharia principles. But what we should consider is the income of conventional bank is not only from the interest, but also from the fee that gain by the bank on providing the transaction services. Therefore, the assumption is that the capital for Islamic Business Unit is from *halal* fund and not from the interest (Wiroso, 2011).

4. Financing Based on Islamic Perspective

Islamic banking does not utilize the term debt or credit except financing. According to Muhammad (2005) financing, in a wide meaning can be defined as expenditure, namely financing spent to support investment budgeted, whether it is conducted by itself and conducted by other people.

Financing based on the Islamic principle means providing money or bill to other party funded and given by the bank based on mutual deal and the party funded is obliged to return the amount of money in a particular term through compensation of profit sharing financing fund in the form given by the person owned the fund to the party used this fund is based on the trust. It is different with the credit given by conventional bank, the financing provided by Islamic bank does not contain return in the form of interest, but in other form according to the contracts provided in Islamic bank (Ismail, 2010).

The main difference between credit provided by conventional bank with the financing given by the bank based on the Islamic principle is focused on the expected profit. Profit of banks that based on the principle of conventional earned through interest, whereas for the bank based on the Islamic principle it earned through rewards or profit sharing. The other difference consists on the analysis of credit given including the terms (Kashmir 2008).

Profit sharing financing is expected to be a substitute for conventional bank usury. Profit sharing financing is also based on the trust of both parties involved. Islam is allowing profit sharing and prohibiting riba through interest. Both of them provide profit, but have basic differences due to the existence of investment and interest given to money. Investment encourages business conducted containing risk and uncertainty, whereas interest of money is an activity that is not contained risk due to the percentage of interest stated of the number of capital (Antonio 2009).

5. Profit Sharing Financing

According to *Undang-Undang No.10 Tahun 1998*on banking, financing based on Sharia principle is provision of money or equivalent bill based on agreement or deal between bank and another party, which requires the financed party to return the money or bill after certain period of time with remuneration or profit sharing.

Profit sharing is a system which applies revenue distribution procedure between fund provider and fund manager. Generally, profit sharing principle in syariah uses four primary contracts, i.e *al-musyarakah, almudharabah, al-muzara'ah*, and*al-musaqah*. The most commonly used contract of the four in syariah are*al-musyarakah*and*al-mudharabah* (Antonio,2009).

a. *Mudharabah*

Mudharabah is derived from *adhdharbu fil ardhi*, meaning traveling for trade business. The words of Allah on surah 73 verse 20, "they travel throughout the land seeking the bounty of Allah". It is also called *qiradh* from the word *al qardhu*which means al qath'u (cut) because the owner cut a part of their wealth to be traded and received some profit. Technically *mudharabah* is agreement of cooperation between two parties where the first party (*shahibul mal*) provides all capital and the other party becomes the manager. Business profit of mudharabah is distributed by agreement in contract, while in case of loss it will be borne by the capital owner as long as the loss isnot due to the manager's negligence. In case the loss is due to the manager's cheating or negligence, the manager must be responsible for the loss.

In syariah banks, *mudharabah* agreement is applied to financing and funding products. In terms of fundraising, *mudharabah* is applied on savings deposit and special deposit. In terms of financing, *mudharabah* is applied for financing work capital and special investment (Antonio, 2006).

b. *Musyarakah*

Musyarakah according to Rastono (2008) is cooperation agreement between two or more parties for certain business where each party contribute some fund (charity/expertise) with agreement that profit and risk are borne together consistent with the agreement. The *musyarakah*system is the basic concept of islamic bank. In this case, the relation between bank and customer is cooperation, not relation between creditor and debtor as in conventional banks.

Mudharabah and musyarakah profit sharing principles are different from fixed interest principle where bank will bill the financing recipient (customer) a fixed amount of interest no matter the profit produced the customer, despite loss and economic crisis (Rastono ,2008).

6. Capital Adequacy Ratio

Generally, Capital Adequacy Ratio (CAR) is an analysis tool which used to know the amount of capital needed in an operational activity and a reserve for loss which can be happened in a bank (Kuncoro and Suhardjono, 2002). Based on *Peraturan Bank Indonesia No. 17/11/PBI/2015*, each bank has been obligated to provide 14 percent as the minimum capital (Bank Indonesia, 2015). In other terms, Capital Adequacy Ratio (CAR) is a ratio that shows the amount of the total assets of bank which contains risk elements (credits, inclusions, securities, or bills to other banks) which paid from the bank's capital itself, beside the non-bank funds from other sources (Dendawijaya, 2009).

As a matter of fact, the requirement for minimum capital that should owned by the bank is always changing. The change is basically depends on the average healthiness of a bank in the world. This requirement for minimum capital is adjusted with the international Capital Adequacy Ratio which established by Bank for International Settlement (BIS).

The changes which set by Bank for International Settlement (BIS) on Capital Adequacy Ratio aim to increase the performances of the bank, so it could be far from the bankruptcy (Dendawijaya, 2009). This is very important for a bank, because by preserving required capital, a bank could gain the trust from the society. The reason is when the trust from the society increase, a bank can increase its operational activity (Sinungan, 2000).

For the reason that capital is an important factor in operation of a bank's abilities, such as the expansion of the bank and the ability to overcome the loss, Capital Adequacy Ratio is really affected by so many factors (Rivai, 2007), such as:

a. Types of assets and risks, either they are administratively record or not
b. The Quality of assets or collectability rate as the measurement on the possibility of funds which will be received back in the future.
c. The total assets of bank. It does not matter whether a bank has a big amount of assets, due to the fact that each asset has its own risks; the bigger the amount of asset, the bigger the risk.

7. Return on Asset (ROA)

Return on Asset (ROA) is a ratio to measure the ability of a bank on generating profits, by using total assets that owned by the bank after it is suited with the fees for marking the asset (Hanafi, 2008). Return on Asset can also be defined as the analysis tool to measure the ability of the bank management on generating profits as a whole (Dendawijaya, 2009). The high value of Return on Asset in a bank indicates a better performance in the bank itself. The value of Return on Asset also shows how well the financing flow in the real sector (Wild, Subramanyam, and Halsey, 2005). Simply said, the purpose of Return on Asset (ROA) is to measure the ability of a bank on generating profits.

As one of profitability ratio, Return on Asset (ROA) shows a combined effect between liquidity, assets management, and loan as a result from the operational activity (Brigham and Houston, 2001). So, there are no wonder if Return on Asset (ROA) also influenced by many factors, such as:

a. Liquidity Ratio, this ratio measures the ability of a bank on fulfilling its short-term obligation by comparing the sub-standard assets with the sub-standard obligations.
b. Assets Management Ratio, this ratio measures the effective of a bank on managing its assets.
c. Debt management Ratio, this ratio measures the ability of a bank on fulfilling its long-term obligation and all firms activities.

Not only acts as the profit measurement tools, Return on Asset also has other functions (Abdullah, 2005), such as:

a. ROA measures the efficiency rate of operating capital, the efficiency of production and the efficiency of marketing division.

b. ROA compares the efficiency rate of one bank and other banks with similar specification by showing the disadvantages and the advantages of them.
c. ROA measures the efficiency rate of division by allocating fund and capital to the relevant division.
d. ROA measures the profitability of each product that provided by bank.
e. ROA becomes the decision maker when it comes to an expansion.

8. Inflation

Generally, inflation is an increase on price of goods and services within certain period (Karim, 2008). In other term, inflation is a continuous increase on price of goods and services (Rahardja and Manurung, 2004). Inflation also can be defined as an increase of price of goods and services, as the impact of an increase of demand compared to the amount of supply on the market. Simply said, the amount of money supply is higher than the amount of goods and services (Sukirno, 2004).

In light of the fact that inflation affected by many factors, inflation divided into five types (Karim, 2008), such as:

a. Natural Inflation and Human Error Inflation. Natural Inflation is an inflation that happens naturally where human has no power to avoid it. Human Error Inflation is an inflation that happens because of human error
b. Actual/Expected Inflation and Unanticipated/Unexpected Inflation. Expected Inflation is a condition where the interest rate of real loan is

equal with the interest rate of nominal loans minus by inflation. Unexpected Inflation is a condition where the interest rate of nominal loan has not reflected the compensation on inflation effect yet.

c. Demand Pull Inflation and Cost Push Inflation. Demand Pull Inflation is affect by the changes on aggregate demand side (goods and services). Cost Push Inflation is affected by the changes on aggregate supply side (goods and services).
d. Spiraling Inflation. This type of inflation is affected by the inflation on the previous period.
e. Imported Inflation and Domestic Inflation. Imported Inflation is an inflation that affected by other countries because those other countries are the price taker on international trade. Domestic Inflation is affected by an inflation that happens in other countries and not affected the other countries in the same circle

In Islamic perspective, inflation has many bad impacts for the economy (Karim, 2008), these happen due to the fact that:

a. The function of money is disturbed, especially the function of savings, down payment and measurement unit.
b. The society becomes less passionate on savings their money.
c. The society tends to spend their money on non-primary and luxury goods.

d. The society tends to invest their wealth on non-productive goods, such as; land, building, gold and foreign currency.

9. Sharia Certificate of Bank Indonesia (SBIS).

Regarding main function of Bank Indonesia to create and maintain the stability of value of Rupiah, Bank Indonesia made a special instrument for Islamic Banking, i.e *Wadiah* Certificate of Bank Indonesia (SWBI) which is known called Sharia Certificate of Bank Indonesia (SBIS). Based on the regulation of Bank Indonesia No.10/11/PBI/2008 on Sharia Certificate Bank Indonesia (SBIS), SBIS is defined as sharia security based on short-term in Rupiah, which is published by Bank Indonesia (www.bi.go.id). Several characteristics of SBIS are:

a. Using *Akad Ju'alah*

b. Using Rp 1.000.000 (One Million Rupiah) /unit

c. Having the shorted period of 1 month and the longest of 12 months.

d. Able to pledged to Bank Indonesia.

e. Unable to be traded in secondary market.

Based on the Circular of Bank Indonesia No.10/40/DPM dated 17 November 2008 on publication method of Sharia Certificate of Bank Indonesia (SBIS), its performed using auction mechanism. The administration of SBIS uses electronic recording and administrative systems known as BI-SSSS (Scripless Securities Settlement System), which is transaction with

Bank Indonesia, including it administration and administration of securities electronically and with direct relation between participants, administrators and Bank Indonesia system. Real Time Gross Settlement (BI-RGTS) and benefit from SBIS are not interest but called bonus.

B. Previous Researches

There are plenty of research on Islamic bank financing. Each research comes with different analysis tools and results. Here is come researches on Islamic bank financing:

1. Muhammad Luthfi Qolby (2013) conducts a study entitled “ The factors affected the financing of Islamic Bank in the period of 2007-2013”. The finding show that the variable of Third Party Funds (DPK) affects postive to the financing of Islamic bank both in a short term and a long term. The variable of *Return On Assets* (ROA) affects no significant and positive both in a short term and a long term
2. Leni Untari’s (2016) research entitled “The Influences of Depositors Fund (DPK), Cash and Sharia Certificate of Bank Indonesia on Mudharabah and Musyarakah Financing in Islamic Banking period 2010-2014”. The analysis technique is Multiple Linear Regression. The findings show that Depositors Fund (DPK) influences Mudharabah and Musyarakah Financing positively significant. On the contrary, Cash and Sharia Certificate of Bank Indonesia

(SBIS) influence Mudharabah and Musyarakah Financing negatively and significant.

3. Rahmi Fajriyanti (2014) conducts a study entitled “ The analysis of third party funds, Capital Adequacy Ratio, Non Performing Financing, and Return On Asset to the financing of public islamic bank in period 2009-2013”. The finding Show that the level ofDPK, CAR, NPF, and ROA affects significant to the financing with the probability value of 0.0000. Partially, the result of the reasearch shows that the level of DPK and NPF affects positive to financing whereas the level of CAR and ROA affects negative to financing.
4. Nur Gilang Giannini (2013) conducts a study entitled “ The factors affected Mudharabah financing to public islamic bank in indonesia”. The finding show that, FDR, NPF, ROA, CAR and the level of profit sharing level simultaneouslyaffect to mudharabah financing, whereas ROA, CAR and the level of sharing profit affect positive to mudharabah financing.
5. Study from Nugroho (2009) analyzed the factors that determine the financing of islamic banking in indonesia. The research is used *Vector Error Correction Model.* The result of the research showed that the existence of cointegration between islamic banking financing and troubled financing, profit per asset, Sharia certificate of Bank Indonesia, public bank credit, industry production index, Jakarta *Islamic Index* and the fund of islamic bank from third party. In long term, the troubled financing and public bank credit

significanly affect financing of Islamic banking. Shock from troubled financing, Sharia Certificate of Bank Indonesia (SBIS), public bank credit, the index of industry production and Jakarta Islamic Index in long-term the response is negative to financing of Islamic Banking, whereas profit inovation per asset, third party funds, and financing itself in long-term are responded negative permanent by the financing of Islamic banking. Based on dinamic contribution of each determinant, the biggesr aspect that explains financing variability is troubled financing, then the financing itself and public bank credit. Based on the origin of contribution, the side of supply provides a bigger contribution than demand side.

6. Hikmawan (2013) tested the effect of *Capital Adequacy Ratio* (CAR), *Non Performing Financing* (NPF), interest rate of credit investment, inflation, bruto domestic product, fund of third party to the volume of sharing profit financing of BUS in 2006-2012 of indonesian period. The result of the research showed that CAR, NPF and DPK affect positive to the financing of profit sharing. The interest rate of investment credit and inflation does not affect to sharing profit financing. Whereas, PDB variable affect significant and negative to the sharing profit financing of public islamic bank.
7. Irfan Syauqi and Winda Nur Aprianti (2013) conducts a study entitled "An Analysis of Factors Affecting Islamic Banks in Financing the Agricultural Sector in Indonesia". The objective of this research is Islamic banking industry. This research uses the monthly data within period of Juy 2004 to

December 2010. The method of analysis is VAR/VECM. The findings show that Sharia Certificate of Bank Indonesia SBIS, Conventional Rate of Bank Indonesia Certificate (SBI), Equivalent Rate of Financing (ERP), Equivalent Rate of Depositors Fund (ERDPK) affect financing on agicultural sector in long-run positively significant. On the contrary, Depositors Fund (DPK) and Interest Rate shows a negative relationship with financing on agritural sector. In addition, Inflation and Non-Performing Financing (NPF) are not affecting financing on agricultural sector neither in the short-run nor in the long-run. The main suggestion is to increase the quality of financing scheme by the Islamic banking industry.

8. Muhammad Zakki Fahrudin's research entitled "The Influences of Inflation, Capital Adequacy Ratio (CAR), Credit Risk, Depositors Fund and Banking Network on Financing in Islamic Commercial Banks period 2006-2008". The research uses the data of three Islamic Bank; Bank Muamalat Indonesia, Bank Syariah Mandiri and Bank Mega Syariah Indonesia within period of 2006 to 2008. The tool of analysis used in this research is Multiple Linear Regression. The findings show that Inflation CAR and Credit Risk influence the Islamic bank financing negatively significant. On the contrary, Depositors Fund (DPK) and Islamic Banking Network have positive and significant effect towards Islamic bank financing.

C. Theoretical Framework

1. The Effect of Capital Adequacy Ratio (CAR) to Profit Sharing Financing.

Capital Adequacy Ratio (CAR) is an analysis tool to measure the amount of capital to support banking operation and to prevent future loss (Kuncoro and Suhardjono, 2002). The amount of capital owned by bank is basically also used to set the maximum amount of financing. So, when a bank wants to provide financing, it will influence a lot by the amount of capital owned by bank (Muhammad, 2002).

According to Hikmawan (2013) study stated that CAR affects positive and significant to profit sharing-based financing. The higher CAR ratio of the bank thus it will make profit sharing-based financing higher that is distributed by islamic bank. However, it is different with the result of Rahmi's and Fahrudin'sresearch, it stated that Capital Adequacy Ratio (CAR) affects negative and significant to financing.

Therefore, the researcher predicts that Capital Adequacy Ratio (CAR) will affect profit sharing financing negatively.

2. The effect of Return on Asset (ROA) to Profit Sharing Financing.

ROA is an ability measurement of bank management in gaining profit completely. If the level of ROA a bank is high, thus the higher also profit gained by the bank and the better position the bank from the perspective of asset security.

The higher of ROA level will cause the financing of a bank more increasing, this is caused by more effort of management in investing its profit in various activities that make profit, especially in distributing financing.The result conducted by Qolby (2013) dan Giannini (2013) shows that ROA affects to the financing of islamic bank postively and significant.

Therefore, the researcher predicts that Return on Asset (ROA) will affect profit sharing financing positively.

3. The effect of Sharia Certificate of Bank Indonesia (SBIS) to Profit Sharing Financing.

Bank Indonesia Wadiah Certificate (SWBI) has changed recently its name to Sharia Certificateof Bank Indonesia (SBIS).Based on the regulations of Bank Indonesia no.10/11/PBI/2008 regarding Sharia Certificate ofBank Indonesia (SBIS). The definition of SBIS is a valuable letter based on short-term sharia principle in Rupiah currency issued by Bank Indonesia.

Once the amount of SBIS increase the total financing will be decreased due to excessive fund saved in the form of SBIS, then the fund that will be used for financing will decrease. Otherwise, if the number of SBIS decreases thus the financing will raise because excessive fund is not saved in the form of SBIS. However, this is used in distributing financing so that it might increase the number of financing distributed.

Based on the research ofUntari and Nugroho, it stated that the variable of Bank Indonesia Wadiah Certificate affects negatively significant to the volume of profit sharing-based financing. The increasing of fund saved in the form of Sharia Certificate of Bank Indonesia (SBIS) has not surely used to increase financing proportion given. There is indication that the bank is interested to distributed its fund to the community mentioned as the fund of third party.

Therefore, the researcher predicts that Sharia Certificate of Bank Indonesia (SBIS) will affect profit sharing financing negatively.

4. The Effect of Inflation to Profit Sharing Financing.

Generally, inflation has many bad impacts, such as; the decreases on the amount of investment, the increases on the interest rate, the increases on depositors speculation, the unstableness in economy, and the decreases of society welfare. These bad impacts will make the decreases on the amount of Islamic banking financing (Karim, 2008).

The inflation level increased will affect the increasing of interest rate of financial institutions and it will affect to the increasing of financial lease level. This will affect to the decreasing of banking asset and to the distribution of credit.

According to research, inflation influences financing on Islamic banking negatively and significant on financing (Fahruddin, 2009). Other similar research that the inflation influences the financing on Islamic banking negatively (Irfan and Winda, 2013).Therefore, the researcher predicts that inflation will affect profit sharing financing negatively.

D. Hypothesis

On the basis of previous research questions, research objectives, theoretical backgrounds, previous researches' results and research framework. This study develops these following hypotheses:

1. There is positive impact of Capital Adequacy Ratio (CAR) to Profit Sharing Financing period 2011-2016.
2. There is positive impact of Return on Asset (ROA) to Profit Sharing Financing period 2011-2016.
3. There is negative impact of Sharia Certificate of Bank Indonesia (SBIS) to Profit Sharing Financing period 2011-2016.
4. There is negative impact of Inflation to Profit Sharing Financing period 2011-2016

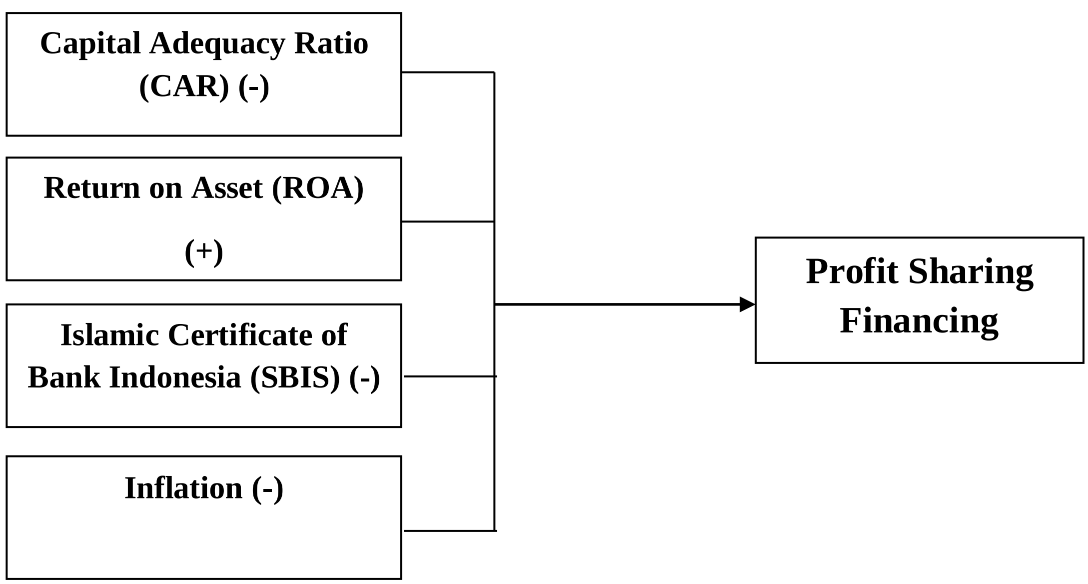

Figure2.1 Research Framework