CHAPTER II

LITERATURE REVIEW

A. Theories

1. Islamic Bank

Bank is a business entity that collects funds from the public in the form of savings and distributes it to the community in the form of credit and other forms in order to improve the standard of living of the people. While sharia banking is a banking system that is developed based on sharia (law) of Islam.

According to Rivai (2007), sharia bank is a bank that conducts its business activities based on sharia principles, namely the rule of agreement based on Islamic law between banks and other parties for the storage of funds or financing of business activities, or other business activities declared in accordance with the principles of sharia. Meanwhile, according to Ismail (2011), Islamic Bank is a bank whose activities refer to Islamic law and in its activities do not charge interest nor pay interest to customers.

In general, Islamic banks are financial institutions whose main business is providing financing and other services in traffic in payments as well as money circulation which operates in accordance with the principles of Islamic Sharia (Yuliadi, 2001: 127)

Islamic view of the bank states that sharia banking is a bank that runs the banking business by embracing a sharia system based on Islamic law. In Islamic law, it is stated that usury is forbidden.

The establishment of this system is based on the prohibition in Islamic religion or to collect and borrow with interest or called with usury and prohibition of investment for categorized haram business, because in this system the procedures in operating based on the Islamic way , which refers to the provisions of Al-Qur'an and Al-Hadith (Muhamad, 2014)

Islamic banks do not apply the interest system but implement a revenue-sharing system that is the management of funds in the Islamic economy. Calculations are based on the consensus of the bank with the customers who invest their funds in sharia banks.

In the Qur'an an Surah Ali Imran verse 130 which reads:

يَا أَيُّهَا الَّذِينَ آمَنُواْ لاَ تَأْكُلُواْ الرِّبَا أَضْعَافاً مُّضَاعَفَةً وَاتَّقُواْ اللّهَ لَعَلَّكُمْ تُفْلِحُونَ

وَاتَّقُواْ النَّارَ الَّتِي أُعِدَّتْ لِلْكَافِرِينَ

O you who believe do not eat usury doubled and fear you to Allah that you may be lucky (Qs.Ali Imran: 130)

In this verse is not directly explained that in Islam more recommends sharia banks that use the system of profit sharing compared conventional banks that clearly use the system of interest.

In the Act No. 10 of 1998, article 1 (13) concerning banking, stating that: The principle of sharia is a rule of agreement based on sharia

law between banks with other parties for storage of funds and financing other business activities declared in accordance with sharia: Financing based on profit-sharing principles (mudharabah), financing based on the principle of equity participation (musyarakah), financing based on the principle of sale and purchase of goods with gain (murabahah), or financing of capital goods based on the principle of pure lease without choice (ijarah).

2. Principles of Operation Sharia Banking

According to Yuliadi (2001), the operational principles of Islamic banks in running their business includes five aspects:

a. Saving system

This principle is a facility provided by Islamic banks to provide opportunities to parties who have more funds in storing funds in the form of *al-wadi'ah*. This facility is provided for the purpose of security and for the benefit of transfer of books, not for investment purposes in order to obtain such benefits on savings and deposits. In the conventional banking facilities *al-wadi'ah* almost same with demand deposits.

b. Profit sharing

This system performs a procedure / mechanism for the distribution of business results between the fund provider *(shaibul maal)* and the fund manager *(mudharib)*. This revenue sharing may occur between the bank and the depositors or between the bank and

the beneficiary customer. The product form based on this principle is *mudarabah* and *musharakah*. Furthermore, easy-to-use principles can be used as a basis for funding production, namely savings and time deposits and financing. Characteristics of the operational principles of Islamic banks is to use a system of different essential share with the interest system (Yuliadi, 2001: 128).

c. Principles of buying and selling and profit margins

This principle is the determination of the procedure of buying and selling *(al-bayu ')* in this case the bank will buy the first goods needed or appoint customers as a bank agent or as the bank's power to member the goods. And the customer in certainty as an agent or the power to purchase goods on behalf of the bank then the bank sells the goods to him with the price of a certain amount of purchase price plus profit.

d. Lease principle (Ijarah)

This principle is broadly divided into two: ijarah (pure lease) such as the leasing of the means of production is often called the operating lease and bai 'at-tikri (lease purchase) in which the tenant has the right to own the goods at the end of the lease term or often called financial lease.

e. *Fee*

This principle covers all non-financing services provided by the bank. The form of product based on the principle of the fee, among

others, bank guarantee, kliring, inkaso, collection, transfer service and others.

According to Karim (2010),the products offered by sharia banking can be divided into three major sections, namely fundraising products, fund distribution products, and service products.

According to Yuliadi (2001), the products of Islamic banks in outline are as follows:

1. Product channeling of funds

   a. Giro *Wadi'ah*

   Client's funds deposited in Islamic bank at any time the customer is entitled to take it and is entitled to get the bonus from the profit utilization of demand deposit by the bank. The amount of bonus is not set up in advance but is the policy of the bank.

   b. *Mudharabah* Savings

   The funds deposited by customers will be managed by the bank for investment in order to make a profit. The amount of profit for the customer based on the agreement. This type of savings can be instituted according to the necessary requirements.

   c. *Mudharabah* Investment Deposits

   The product requires that the funds held can only be withdrawn based on a predetermined period of time with for-profit based on such profits

d. *Mudharabah* Hajj Savings

Funds deposited by third parties withdrawal at the time of the customer will be a pilgrimage, or certain conditions in accordance with the agreement. The amount of the benefit is determined on the basis of profit sharing *(Mudharabah).*

e. Saving Qurban

Third party deposits accumulated for Qurban services withdrawals are made at the time the customer will perform the qurban service or upon agreement between the bank and the customer. Profit sharing based on profit sharing principle *(mudarabah)*

3. Profitability of Islamic Bank

Profitability is the ratio that is used to see the ability of the company in generating profit. As with other commercial banks, the main task of Bank Syariah in achieving profit is to optimize profits, minimize risks and ensure the availability of adequate liquidity. The profit rate generated by the bank is known as profitability. According(Hasibuan, 2005) profitability is a bank's ability to earn profits expressed in percentage.

Definition of profitability according to (Dendawijaya, 2009) Profitability of banks is a tool to analyze or measur e the level of business efficiency and is one of the basic assessment of the condition of the company concerned, each company will strive to improve the company's

performance in order to improve productivity and corporate profits, a measure that describes the financial condition of a bank. For customers, before they deposit their funds in a bank then they will see first the financial performance of the bank through financial statements in the form of the balance sheet and profit and loss.

(Athanasoglou, 2006) states that bank profitability is a function of internal and external factors. The researchers agree that internal factors affect bank profitability such as capital size, risk management, and cost management, while external factors that need to be considered are inflation, interest rates, money supply, and exchange rates, and variable outputs that present market characteristics. this study emphasizes on external factors such as inflation, the number of circulating units, interest rates, and exchange rates.

Profitability ratios are used to measure the ability of the company in its business to gain profit by using the active owned. Profitability becomes so important to know whether the company has run his business efficiently or inefficiently. The new business efficiency can be determined by comparing the profits earned by the assets or capital that generate the profit.

One indicator that is used to see the financial performance from profitability side is Return On Asset (ROA). According to (Riyadi, 2006), Return On Asset (ROA) is profitability ratio showing a comparison

between profit before tax with total bank asset, this ratio shows the level of efficiency of asset management performed by the bank concerned.

a. Return On Asset (ROA)

Return On Assets (ROA) is a ratio used to measure the ability of banks to gain profit (profit before tax) resulting from the total assets of the bank concerned(Riyadi, 2006). The greater the ROA, the greater the level of profit achieved by the bank so that the possibility of a bank in the troubled condition is getting smaller. Profit before tax is net income from pre-tax operating activities. While the average total asset is the average volume of business or asset. ROA is formulated as follows:

$$\textbf{ROA} = \frac{\text{profit before tax}}{\text{Total Assets}} \times 100$$

4. Theory of financial system

A stable financial system will create trust and supportive environments for depositors and investors to finance their funds to financial institutions including ensuring public interest. The financial system can be defined as a collection of institutions, markets, regulations, and techniques in which securities are traded, and interest rates are set, and other financial services (Rose, 2002)

The financial system consisting of financial authority, the banking system, and non-bank financial institution system. Basically, it is an order in the economy of a State which has an important role in providing

financial services facilities. These financial services facilities are provided by financial institutions including money market and capital market.

A stable financial system is a strong financial system and resilient to various economic shocks so as to remain capable of performing an intermediary function, performing payments and paying risks well.Financial system stability is a system in which economic mechanisms in pricing, fund allocation, and risk management function well and support economic growth.

The importance of financial system stability has a direct influence on macroeconomic stability in a system of economy. On the contrary, when macro stability fluctuates financial stability will get the impact. Macroeconomic conditions such as the stabilization of public purchasing power, strong domestic demand, and the stabilization of the rupiah exchange rate can have a positive effect on the stability of the financial system.

5. Financial system stability

Financial system stability (SSK) is a stable financial system that is able to allocate resources and absorb shocks (Shock) that occur so as to prevent disruption to the activities of real sector and financial system (Bank Indonesia).

The financial system plays a very important role in the economy. As part of the economic system, the financial system serves to allocate funds from those who experience surplus to the deficit. If the financial

system is unstable and does not function efficiently, the allocation of funds will not run well so that it can hamper economic growth (Bank Indonesia).

A stable financial system is a strong financial system and resilient to economic disruption so as to remain able to perform the intermediary function, perform payments and be able to absorb risks well. Understanding the stability of the financial system can be done by knowing the factors that can lead to instability in the financial system. The instability in the financial system can be triggered by various causes and upheavals. This is due to market failure, either structurally or behaviorally.

To maintain the stability of the financial system, it is necessary to control the factors that may interfere and affect the financial system. In general, there are factors that affect the performance of financial systems, namely endogenous factors derived from within the financial system and exogenous factors derived from outside the financial system. Endogenous and exogenous factors affect the performance of financial systems through market institutions and financial infrastructure.

6. Theory of economic stability

Macroeconomic stability is a fundamental factor to ensure sustainable economic growth. Efforts to maintain macroeconomic stability are carried out through certain measures to strengthen the resilience of the domestic economy against various shocks that arise, both from within and

from abroad. The coordination of fiscal, monetary, real sector and regional policies is absolutely necessary to anticipate the economic turmoil and promote economic growth. The effort is also accompanied by a program of development activities which in its implementation is required to include measures to control inflation, exchange rate stability, and low-interest rates.

Improved economic stability is supported by measures within the financial sector that encourage faster economic activity. To improve the performance and sustainability of the financial sector as a source of funding for development, the financial sector policy is directed at maintaining the resilience of the financial services industry, enhancing the intermediation function of public funds, and developing the financial sector safety net system. As a financial institution that has the largest financial intermediation function in Indonesia, national banking is directed to be more instrumental in encouraging development in various sectors with more equitable distribution of credit throughout the country, as well as affordable by all economic sectors, especially micro, small and medium enterprise (UMKM).

Economic stability is a basic requirement for achieving the improvement of people's welfare through high growth and improving the quality of growth. Economic stability is very important to provide certainty of business for economic actors. Macroeconomic stability is achieved when the main macroeconomic variables are in equilibrium, for

example between domestic demand and national output, the balance of payments, fiscal receipts and expenditures, and savings and investments. The relationship does not always have to be in the right balance. Fiscal imbalance and balance of payments, for example, remain in line with economic stability as long as it can be financed sustainably.

The unstable economy creates high costs for the economy and society. Instability will make it difficult for the public, both private and domestic, to plan ahead, especially in the longer term needed for investment. A low level of investment will decrease the potential for long economic growth. The high fluctuations in production output growth will reduce the skill level of the long-unemployed workforce. High inflation and high fluctuations pose enormous costs to the community. The heaviest burden due to high inflation will be felt by poor people who experience a decrease in purchasing power. Fluctuating high inflation makes it difficult to distinguish price movements caused by changes in demand or supply of goods and services from the general rise in prices caused by excess demand. As a result, there is an allocation of resource inefficiency.

The macroeconomic environment is one of the main factors in maintaining economic stability since macroeconomic variables will directly affect the industry, agriculture, trade, finance, and banking sectors. In the financial and banking sectors, it will directly affect the company's operations in making policy decisions related to the bank's financial performance. Factors influencing management decisions in

banking are internal and external factors. Determinants Internal factors consist of liquidity and cost management. All internal variables are considered to be controlled by bank management. Related to the bank's operational policies and strategies. While external factors (factors that come from outside the company) include monetary policy, exchange rate fluctuations, and the rate of inflation, interest rate volatility, and the amount of money circulating in the society.

a. Exchange Rate

the exchange rate is a value indicating the amount of domestic currency required to earn one unit of foreign currency (Sukirno, 2002) .Meanwhile, according to (Triyono, 2008) exchange rate is the exchange between two different currencies, which is a comparison of the value or price between the two currencies.

The exchange rate of a currency affects the economy if the currency exchange rate is appreciated or depreciated. Fluctuations in exchange rate changes are the focus of the foreign exchange market. Trade between the State where each State has its own currency means that the ratio of the value of a currency to another currency, which is called the exchange rate or foreign currency.

The exchange rate system can be classified according to how much the exchange rate is controlled by the government, the category of exchange rate system according to(Madura, 2008) is as follows:.

1) The fixed exchange rate system

   The fixed exchange rate system is a monetary system where the exchange rate is made constant or only allowed to fluctuate within very narrow limits. If the exchange rate starts to move too sharply then the government can intervene to maintain within the limits in question.

2) The floating exchange rate system

   In this system, the floating exchange rate is a monetary system in which exchange rate is allowed to follow market forces without intervention from the government, within this system multinational companies need to submit substantial resources to measure and manage foreign exchange risk.

3) The floating exchange rate is under control

   A monetary system in which the exchange rate is allowed to fluctuate indefinitely, but the central bank may intervene to influence the movements of the exchange rate.

The ups and downs of currency exchange rates can occur in various ways, it can be done officially by the government of a country that embraces managed floating exchange rate system. Currency exchange rate changes can occur due to 4 (four) things, namely:

a) Depreciation (Depreciation), That is the decline in the price of the national currency against various other foreign currencies,

which occur because of the attractiveness of supply and demand forces in the market (market mechanism).

b) Appreciation is the increase in the price of national currency against various other foreign currencies.

c) Devaluation is the decline in the price of national currency against various foreign currencies that are done officially by the government of a State.

d) Revaluation is the increase of the national currency to foreign currency against other foreign currency which is done officially by the government.

b. Inflation Rate

One important indicator to maintain the economic stability of a country by keeping macro variables one by keeping the inflation rate in the country in order to keep the balance, High inflation rate is usually associated with overheated economic conditions, the economic condition is experiencing demand over products that exceed their supply capacity, so prices tend to increase.

According to Tandelilin (2010), inflation is a tendency in increasing the price of the product as a whole, resulting in a decrease in the purchasing power of money. Inflation is the increase of prices in general and continuously related to market mechanism which can be caused by various factors, increased publicity, excess liquidity on the

market that triggers consumption or even speculation, or includes the consequences of non-current distribution of goods.

Inflation is the process of an event that is used as an indicator to see the rate of change and is assumed to occur if the process of price increase takes place continuously, theoretically, inflation rises in the price of goods in general and continuously. Thus, inflation cannot be said when the increase occurs only in small groups of goods and price changes that occur only once (Yuliadi 2008).

Inflation is measured by the rate of inflation that is the rate of change from the general price level. The perspectives are as follows (Karim, 2008: 136)

Rate of inflation = $\frac{pricelevel1-pricelevel-1}{pricelevel-1}x100$

The research used in measuring inflation is the composite consumer price index (IHK). Based on the inflation rate, inflation can be divided into three categories, namely:

1) Creeping Inflation

   phenomenon of creeping inflation is characterized by low inflation rate, ie less than 10% per year.

2) Galloping Inflation

   Galloping inflation is an inflation marked by a considerable increase in price and the condition runs in a relatively short time and has accelerated properties, the price of the next month or week is always higher than the previous time

3) Hyper inflation

Hyper inflation is a worrying inflation as the price of goods increases by five or six times, so the value of money drops sharply (Nopirin, 1990).

While inflation according to the causes, can be divided into two kinds. They are:

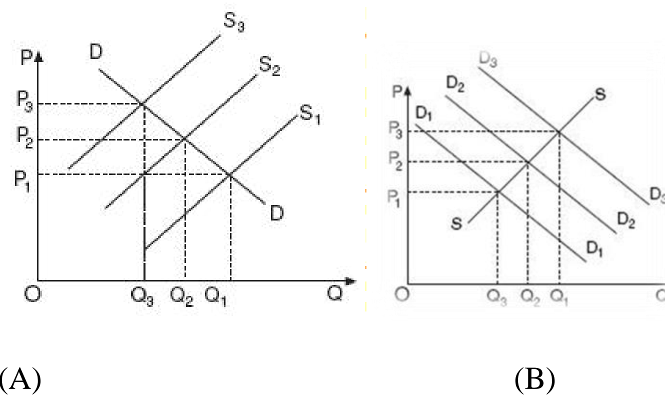
1) Cost-Push Inflation

Inflation is due to an increase in production costs. The increase in production costs is due to rising raw material prices, for example, because of the success of unions in raising wages or due to rising fuel prices. The increase in production costs resulted in rising prices and inflation occurring.

2) Demand push inflation

Demand pull inflation is the inflation that occurs due to the influence of demand (demand) which is not matched by an increase in the number of product offerings. This results in an increase in the price of goods in accordance with the law of demand that is when demand is high while the supply is fixed then the price will rise. If it happens continuously, there will be prolonged inflation.

The curve below, explains the difference between demand push inflation and cost-push inflation :



(A) (B)

Source : (Boediono, Ekonomi Makro,1995)

Figure A is cost-push inflation. The decrease in production is shown shift curve S1 to S2. The shift in the supply curve, The supply quantity decreases from Q1 to Q2 and raises the price of manufactured goods from P1 to P2, and if production costs continue to rise then prices will rise again from P2 to P3.If this continues it will lead to continuous increases and this situation will cause inflation.

Figure B is the Demand inflation curve, which explains that the curve shift from D1-D2 is due to the addition of Q1-Q2 demand resulting in a rise in the price (P1-P2). If demand continues to increase (Q2-Q3) causes the price will continue to rise (P2-P3), soon. This will lead to a continuous rise in prices leading to inflation occurring

Broadly speaking there are 3 groups of theories about inflation, each theory explains certain aspects of the inflation process:

a) Quantity Theory

In quantity theory, it is explained that the occurrence of inflation is only caused by one factor, which is due to the increase in the amount of money in circulation (JUB). The essence of this theory is that inflation will occur if there is an increase in the amount of money in circulation, either the addition of currency or the addition of demand deposits.

b) Keynesian Theory

According to Keynes's theory of inflation occurs because people want to live beyond the limits of their economic capabilities. The inflationary process according to this view is nothing but the process of sharing the fortune among social groups who want a larger share than the usual by the community. This situation is shown by the public demand for goods that exceed the quantity of goods, goods available. This gives rise to an inflationary gap. When the inflationary gap persists, so long as that process of inflation occurs and continues.

c) Structural Theory

Structural theory is a theory that explains the phenomenon of inflation in the long run. This is based on an explanation that highlights the causes of inflation stemming from the stiffness or inflexibility of the economic structure of a country. In

theory, this inflation is associated with the structural factors of the economy. This theory puts pressure on the resilience of the economic structures of developing countries. Thus this theory tries to see inflation in the long run.

c. Gross Domestic Product

Gross domestic product (GDP) is the monetary value of all finished goods and services produced within a given country in a given period, gross domestic product (GDP) is usually calculated on an annual basis and includes all private and public consumption, government investment and export financing minus imports.

Gross domestic product (GDP) is a macroeconomic indicator that also affects bank profitability. If GDP rises it will be followed by an increase in people's income so that the ability to save (saving) will also increase, this saving increase will affect the profitability of the bank (Sukirno, 2003: 54)

The measure of the success of a country can be seen from the growth of gross domestic product (GDP). GDP that grows sustainably means that the economy is able to produce a larger and aggregate product through the optimal use of resources. This means that by increasing the GDP unemployment rate decreases and the level of prosperity is getting better. Without the support of banking, it is almost certain that the goal of achieving this prosperity is impossible.

Gross domestic product (GDP) is the number of final goods and services produced by the entire community of a country in a certain period. Gross domestic product or GDP in this study is GDP over constant prices. The formula used to find GDP is as follows (Sahara, 2013: 5)

$$\text{GDP} = \frac{\text{GDP} - \text{GDPX} - 1}{\text{GDPX} - 1} \times 100\%$$

Given the importance of stability of macroeconomic variables for the smoothness and achievement of national development targets, the Government must commit to continuing creating and stabilizing macroeconomic stability. One direction of the macroeconomic framework in the medium term is to maintain macroeconomic stability and prevent excessive fluctuations in the economy, especially in maintaining financial system stability through financial institutions including in-country banking.

Macroeconomic stability depends not only on macroeconomic management but also on the structure of markets and sectors. To strengthen macroeconomic stability, macroeconomic policies, through well-coordinated fiscal and monetary policies, should be supported by structural reform policies aimed at strengthening and improving market function, including capital and money markets, labor markets and goods and services markets, and sectors include such as industry, agriculture, trade, finance, and banking sectors.

7. Theory of Performance Bank.

Performance company is an activity aimed at assessing the success of the management of a company, measurement of company performance in principle is to assess the results obtained by the company. In general, performance is the result of the objectives to be achieved by the company measured in a certain period. these measurements can be grouped into 2 (two) namely, the measurement of the financial side of the company (financial performance), and measurement of performance of non-financial companies (financial performance). Financial performance is the periodic determination of financial appearance based on the objective, the predefined working standard, To measure the financial performance used financial analysis because the financial analysis involves the assessment of financial future.

Mishkin (2001) argues that banks are an important institution for external financing in a business of almost all countries. Even the role is even greater in developing countries, not least in Indonesia. The role of the banking industry still dominates the financial system in Indonesia with a share of approximately 77.9 percent of total assets of financial institutions (Bank Indonesia, 2013). The function of banks as intermediary institutions has a strategic role in the development of a country's economy. The performance of a bank both individually and in a system is expected to increase the contribution in the economy.

Assessment of bank performance is required for bank stakeholders such as bank and customer management. According toSari (2010) the bank that always maintains its good performance, especially the high profitability level and able to distribute the dividends well and business prospects can always grow and can fulfill the prudential banking regulation well, then there is a possibility of the company's stock value and the fund of the party third will rise. The increase in the value of shares and the number of third-party funds will be one of the causes of increasing public confidence in the bank concerned.

Performance appraisal is related to bank soundness. According to Law Number 10 of 1998 on "Banking", states that banks are required to maintain the soundness of banks in accordance with the provisions of capital adequacy, asset quality, quality management, liquidity, earnings, solvency, and other aspects related to the bank's business and are obliged to conduct business activities in accordance with prudential principles. Because the purpose of Indonesian banking is to support the implementation of national development in order to improve the equity of economic growth and national stability to improve the people's welfare.

The purpose of company performance assessment according to Munawir (2010), is as follows:

a. To determine the level of liquidity for the ability of companies to obtain financial obligations that must be met or the ability of the company to meet its finances at the time of billing.

b. To determine the level of profitability, which shows the company's ability to make the profit during one period.
c. To determine the level of solvability, namely the ability of the company to meet its financial obligations if the company is liquidated both short-term and long-term financial obligations.
d. To determine the level of business stability, the ability of a company to conduct its business with a stable, measured by taking into account the company's ability to pay interest expenses on the debt of the company and include repaying the principal of its debts on time and the ability to pay dividends regularly to shareholders without any obstacles.

Return On Asset ratio can be used as a measure of financial health. In this research, ROA is used as an indicator of bank performance. ROA is the ratio of earnings before tax to total assets. This ratio shows how much of an asset is available to generate a return or income. According to (Darmansyah, 2014), ROA is used to measure the financial performance of multinational companies, especially when viewed from the standpoint of profitability.

B. Previous Study

The results of some previous studies will be used as reference materials and comparisons in this study. Many types of research have been conducted on factors affecting profitability in Islamic banking financing. Previous researchers include:

A research held by by (Amzal, 2016) entitled "The Impact of Macroeconomic Variables on the Profitability of Bank Indonesia in Indonesia," it states that there is some macroeconomic variables impact on the performance of Indonesian sharia banking. The purpose of this study is to determine the effect of macroeconomic variables on the benefits of Bank Syariah in Indonesia. Macroeconomic variables use Gross Domestic Product (GDP), Inflation Rate, and Bi Rate (Indonesia central bank interest rate). In addition, Non-Performing Finance (NPF) is included in this model to represent another determinant for banks in gaining profits. The econometric model by formulating multiple regression models is used to estimate the impact of GDP, BI Rate, Inflation Rate, and NPF on the profitability of sharia banks. The results of this study indicate that partially, all variables (GDP, Bi rate, Inflation and NPF) have a significant effect on the profitability of Sharia Bank.

In a study conducted by Assegaf, Putri and Syarief (2014), entitled "Analysis of the effect of macroeconomic variables on the financial performance of sharia banks in Indonesia period year 2007-2013" this study aims to determine macroeconomic variables (Inflation, interest rates, money

circulating, and national income) affect the financial performance of Islamic banks seen from the level of profitability (ROA, ROE, NPF), the sample in this study is the Sharia (BUS) and Sharia (Islamic) Business Unit. Data used in this research is secondary data of time series monthly. The results of this study indicate that simultaneously macroeconomic variables that include inflation, interest rates, the amount of money circulating and ROA months ago have a significant effect on the ROA of sharia banks in Indonesia. While partially, except for ROA of the previous month, all macroeconomic variables have no significant effect on ROA. Simultaneously all macroeconomic variables in this study and the previous month's ROE also have a significant effect on the ROE of sharia banks in Indonesia Partially only the interest rate that does not significantly affect the ROE. For NPF, simultaneously all macroeconomic variables and NPF of the previous month significantly influenced NPF of sharia banks in Indonesia. Partially only the interest rate has no significant effect on the NPF.

A research held by by Wibowo (2013) with the title of research "Analysis of the influence of interest rates, Car, Bopo, Npf on the profitability of Sharia Bank" The method of this research is multiple regressions. The results suggest that the first interest rate does not have a significant effect on ROA. Both inflations have a negative direction but do not have a significant effect on ROA. The three CAR variables have no significant effect on ROA. The BOPO variable has a negative effect on ROA, and the NPF has no significant direct effect on ROA.

Based on research conducted by(Saputra, 2015)with the title of The impact of macroeconomic variables on Islamic banking profitability in Indonesia for the period 2010 to 2013 which is proxied by Return On Asset (ROA). The variables of macroeconomic in this research include Inflation, Bi Rate, Gross Domestic Product, Money supply and Exchange rate. The method of this research is Pooled Ordinary Least Square (POLS) or panel data as a tool analysis. The result shows that Bi rate has a negative effect and significant on Return On Asset of an Islamic bank. The exchange rate has a positive effect and significant on Return On Asset of an Islamic bank. And inflation, Gross Domestic Product, and money supply have no significant effect on Return On Asset of an Islamic bank.

Dwijayanthy and Naomi (2009) in his research entitled "Inflation Influence Analysis, Bi Rate, and Currency Exchange Rate on Bank Profitability Period 2003-2007". The result of this research states that inflation has a negative effect on profitability, Bi Rate has no effect on profitability and exchange rate negatively affect profitability.

Based on research conducted by (Sahara, 2013) entitled "Analysis of Inflation Influence, Interest Rate of BI, and Gross Domestic Product to ROA of Bank Syariah in Indonesia. The results of this research indicate that inflation affects ROA. Interest rates negatively affect ROA, and gross domestic product positively affects ROA.

In research conducted by (Sodiq, 2015) with the title of research Influence of Macroeconomic Variables on Profitability of Sharia Bank in

Indonesia Period 2009-2014. The sampling technique used is purposive sampling. The research sample gained from three Islamic banks and the data were obtained from published financial statement of Bank of Indonesia. Data analysis technique used multiple linier regression analysis. Where previously data had been tested with the classical assumption include data normality test, heteroscedasticity, multicollinearity and autocorrelation. F Test result showed that simultaneous variable of Inflation, Gross Domestic Bruto, and Interest Rate have a significant effect on ROA while T Test result showed that partially Inflation haven't a significant effect on ROA while GDP have a positive and significant effect on ROA while Interest Rate have significant effect on ROA.

Based on research conducted by (Pebruary & Irawan, 2017) entitled "Analysis of Macroeconomic Factors on Return On Assets of Islamic Banking (Case Study of Bank Mandiri Syariah)" This study aims to analyze macroeconomic factors (inflation, Birate and Gross Domestic Product) whether it affects Return on Assets (ROA) in sharia banking. The population of research is sharia banking registered in Bank Indonesia period 2009-2016, namely Bank Syariah Mandiri. The purposive sampling method by selecting bank financial statements on a quarterly basis is used as data collection technique. Data is then analyzed using classical assumption test, multiple regression analysis. The results show that inflation, BI rate, and growth of gross domestic product affect ROA.Secara partially, inflation has a positive

effect on ROA, but the BI Rate and growth of gross domestic product show a negative effect.

In a study conducted by (Kusuma, 2016) entitled "The Influence of Macroeconomic Factors on Sharia Banking Profitability in Indonesia Period 2013-2015" This study aims to determine the effect of macroeconomic factors using inflation variables, interest rates and gross domestic product against profitability using ROA sharia banking in Indonesia period 2013-2015. The sampling technique used is the purposive sample with the number of samples of 11 Syariah banks and 116 data processed in the research. The technique of data analysis conducted in this research is with multiple regression which previously had been tested the classical assumption. F test result jointly inflation, interest rate, and gross domestic product have an effect on sharia banking ROA. T-test results show that none of the independent variables that affect the sharia banking ROA. Meanwhile, the value of the coefficient of determination (R2) obtained results 0.116 or 11.6%.

In a study conducted by (Hidayati, 2014) with the research title The Influence of Inflation, Bi rate and Exchange Rate of Profitability of Sharia Bank in Indonesia. This study aims to determine the effect of the infation rate, interest rate (BI rate) and the rate of proftability of Islamic banks in Indonesia. The object of the research includes 11 Islamic banks and 24 Islamic business units. Proftability of Islamic banks is the dependent variables, while infation, the BI rate and the exchange rate is an independent variables. The analysis technique used in this study is multiple linear

regression. The results showed that the rate of infation and exchange rate variables have a signifcant impact on the proftability of Islamic banks. While the BI rate variable has no signifcant effect.

C. Theorytical Framewok

1. The Influence of Inflation on Profitability in Islamic Banks.

Inflation is a tendency of general price increases continuously over a period of time, the increase in the price of one or two items alone can not be called inflation unless the increase is widespread and results in a large proportion of the price of other goods also rising.

High inflation will lead to reduced assets, because with high inflation will cause people's purchasing power, thus reducing assets owned by the company. Increased inflation will reduce the purchasing power of rupiah that has been invested. Therefore, the risk of inflation can also be referred to as the risk of purchasing power. If inflation rises, investors usually demand an additional premium of inflation to compensate for the reduction in their purchases (Tandelin, 2010: 103)

According to Bodiono (2011) states that inflation is a tendency of price-to-price to rise in general and continuously. High inflation will result in lower public purchasing power and lead to an increase in interest rates. The size of the inflation rate will affect the interest rate and financial performance of the particular company in terms of profitability.

2. The Influence of Exchange rate on Profitability in Islamic Banks.

The exchange rate is a value indicating the amount of domestic currency required to obtain a unit of foreign currency (Sukirno, 2002). The exchange rate will determine the return on real investment. A declining currency will clearly reduce the purchasing power of the income and capital gains derived from any type of investment. This investment will affect the bank's operational activities. With the decline in investment demand for financing on Islamic banks will decline. And then it will affect the financial risk of the bank (Rossana, 2007).

3. The Influence of GDP on Profitability in Islamic Banks.

As indicated above, the Gross Domestic Product represents an increase in income by the community. The economy growth when the production factor is at a certain time larger than the previous period. This means that the production factor owned by the community gives an increased return so that the level of welfare has increased. With the increase of welfare through increased community income, the level of consumption of products produced by the company will increase so that will affect the increase in sales of companies that will ultimately increase corporate profits. Thereby increasing ROA.

According to Sahara (2013) in his research states that Gross Domestic Product (GDP) is a macroeconomic indicator that also affects the profitability of banks. If GDP rises, it will be followed by increasing people's income so

saving ability also increases. Increased saving will affect the profitability of sharia banking.

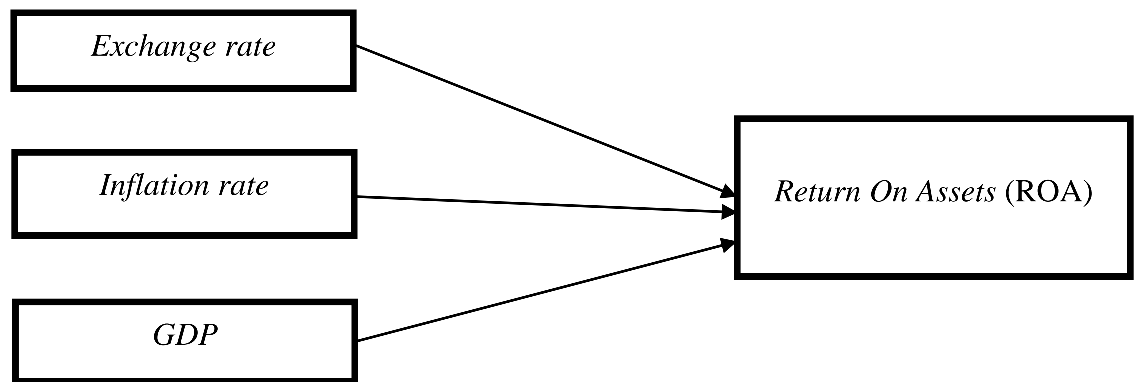


Figure2.1 Theoretical Framework

D. Hyphothesis

Based on the theories, and the previous studies from the background to the exposure of the theoretical basis, the authors build the following hypothesis Based on the above framework, the following research hypothesis can be proposed:

H1: Exchange rate had negative and significant effect on profitability of Islamic banks which is measured by Return On Asset (ROA).

H2: Inflation had negative and significant effect on the profitability of Islamic banks which is measured by Return On Asset (ROA).

H3: Gross domestic product had positive and significant effect on the profitability of Islamic banks which is measured by Return On Asset (ROA).