CHAPTER 2

LITERATURE REVIEW

2.1 Theoretical Foundation

Efficiency is an economic condition when a firm can produce more output than the expended input or by minimizing input to produce same level of output. There are 3 types of efficiency:

- Cost efficiency: measures the difference between the actual and the budgeted cost of producing output
- Standard profit efficiency: measure the difference of profit earned from output and the price of input
- Alternative profit efficiency: measure the difference of bank's profit with the maximal earnings, with certain quantity of inputs and outputs. (Berger & Mester, 1997)

Sharia law is a set of laws which are based on the actions done and the words that are uttered by Prophet Muhammad. Which cover the aspects of human life, the basic laws of Islam is divided into 3 aspects; aqidah (faith), akhlak (ethics) and sharia. Aqidah and Akhlak cannot be changed, while Sharia is constantly changing in order to adapt to the needs and civilization of people. Sharia itself means the way of Allah as guided by Quran and Sunnah (way of life). (Antonio, 2001)

According to Zarqa (1959), the classification of Islam is showed in the following figure 2.1:

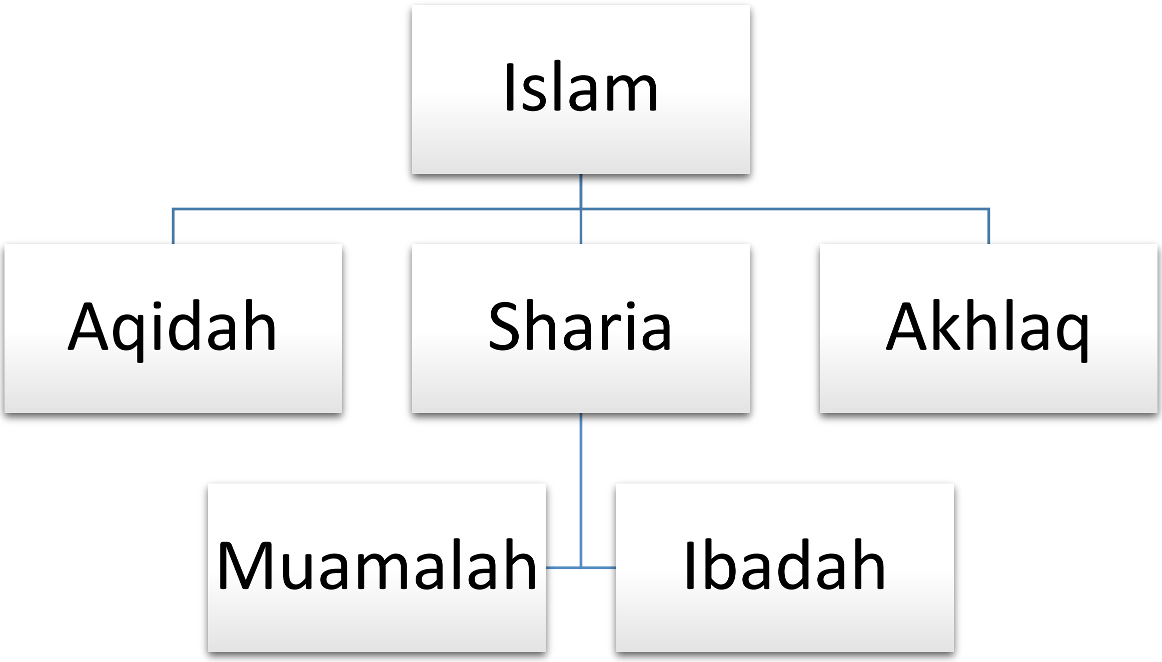

Figure 2.1: Islamic Core principles

Source: (Zarqa, 1959)

Islam is divided to Aqidah (faith), Sharia (law) and Akhlaq (ethics). The Sharia is further classified into 2 aspects:

1. Muamalah: Are the laws which govern the relationship between human beings, it covers all aspects of human lives from needs, lawful actions and prohibition and penalties for the unlawful act.
2. Ibadah: Are the laws which govern the relationship between men and God (Allah). It contains the rules of shalat, the Quran verses for prayers, etc.

In economic aspect, according to Al Islam organization (Seestani, 2006), the Islamic Law covers several things as follows:

1. Taxation (khums): the taxation in sharia principle is 20% of the wealth gained, this tax covers the profit from earning, minerals, treasure, halal and haram property which mixed up, gems from the sea, war spoils, and sale of land to the non-Muslims.

2. Purchase/Sales: the purchase and sales in sharia principle is based on mutual benefits (fairness), this core principle is implemented in all sales and purchase process (include returns), there are several sales transaction which are considered as haram such as intoxicating beverages, living carcass, usurped property, gambling tools, etc. This transaction can be done on cash or credit in a fixed period (considering the debtor cannot pay, the creditor must give time extension or else take back the goods).
3. Leasing: leasing is the usage of rented property in one's business. The sharia stresses the condition of leasing transaction such as; the persons involved in leasing transaction (the lessor and lessee) are adults, sane, and finally able to exercise discretion upon their wealth. there are also conditions that must exist on the leased property by the lessor (such as, the leased good must be specific, it should be deliverable, not to be utilized to its destruction, and the ownership of leased asset)
4. Deposit (Amanah): the rules of deposit are based on trust, both depositor and the receiver must be sane intending and adult, the receiver can decline the deposited property if he is incapable in looking after the property and will not be held responsible if the property is still deposited to him and perished.
5. Partnership: partnership is the combination of two people or more in operating business, the sharia law only consider the partnership as valid if the persons involved in it are adults, sane, intending to become partners and finally able to exercise discretion upon their wealth.
6. Loan: the loan giving is considered as an excellent and the most valued practice in Islamic law, the creditor is encourage to give loan and be lenient to the debtor, if the debtor pays his debt, the creditor should accept them, if the debt period is fixed by the creditor or by mutual understanding, the creditor cannot request payment before the

due date. On the other hand if the debtor cannot pay his debt, the creditor must wait till he/she can pay them. The principle of debt is also the prohibition of riba (usury).

7. Debt Transference (Hawala): the debt transference can happen if the debtor shifts his debt to another person. The conditions of such transference include the acceptance of the third party, the status of the debtor, specific category and quantity of debt. In Hawala, the creditor can decline such transference.
8. Borrowing and lending (Ariyat): Ariyat means that a person gives his property to another person without asking anything in return. This process is voided if the property is usurped, and if the lender of the property dies or incapacitated, the borrower should give the lent property to the lender's heir. This transaction can be rescinded by both parties in any time.
9. Surety (Zamanat): surety is a form of insurance in which one party take over the debt of another party that are experiencing default (The Surety & Fidelity Association of America, 2010).

   The Islamic law allows a person to be a guarantor of somebody else's debt and prohibit him to withdraw from the role after he becomes guarantor of that debt. The surety can be cancelled by the guarantor or the creditor.
10. Personal Guarantee for Bail (Kafalat): Kafalat is a form of personal surety which one can provide for the debtor. the kafalat will be terminated by:
    - When the debtor surrenders to the creditor
    - When the debt has been discharged
    - When the debtor dies
    - When the creditor transfers the debt to someone else
    - When the creditor absolves the guarantor from his personal surety.

11. Obligatory Alms giving/charity (Zakat): Zakat literally means "purification", it is an act of purifying one's wealth to the will of the God by distributing a certain percentage of his/her wealth to the poor and needy (this includes poor people, travelers and the people in debt). The sharia law prescribe the amount of zakat is 2.5% from annual wealth (Muslim Aid, 2014).

The Sharia accounting has its own standards which can be compared to the International Financial Accounting Standards (IFRS); these standards are developed by the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI). The Accounting and Auditing Organization for Islamic Financial Institution was founded in Algiers on 1990. It is a nonprofit corporate body which general aim is to develop financial principles in accordance to Islamic framework. The objectives of AAOIFII are:

1. To develop relevance of accounting and auditing ideas to Islamic financial
2. To disseminate relevant accounting and auditing ideas to Islamic financial institution and its practices through
3. To prepare, interpret accounting and auditing standards for Islamic financial institution
4. To review and revise accounting and auditing standards for Islamic institution.

Developed internationally accepted standards which cover the following:

1. Trading in Currencies: the scope of this standard is applicable to actual and constructive possession of currencies. The exchange of currencies is in the context of bilateral settlement and will not applicable if there is no foreign currency trading in existence; and discounting of bill of exchange. This standard was issued on May 31st 2000. The basis of this ruling are:
    - Evidence of exchange of currencies

- Rule on trading: equality of value in the exchange
- Stipulation of equality and possession
- Constructive possession
- Agency in exchange of currencies and issue of possession
- Use of modern means of communication for trading
- Bilateral promise in currencies exchange
- Exchange of currencies owed by the parties
- Combination of currency exchange and money transfer
- Forms of trading in currencies

2. Debit, Credit and Charge Card: the characteristic of each cards are

- Debit card:
    - Institution issues card for customer with available accounts
    - The card give the right for its holder for cash withdrawal from his account
    - The customer pays no fees for using the card for any transaction
    - Issuance charge is set by the institution
    - Commission charged by third party is calculated as percentage of the payment.
- Charge card:
    - The card provide limited credit facility for its holder (limited to certain time and maximum limit)
    - The card can be used to purchase goods/services and obtain cash
    - The card does not give revolving credit to its holder, the payment must be done in the specified period
    - Additional charges will be attributed to the holder if the payment is delayed beyond the prescribed period

- The bank will receive commission from any party accepting the card as a payment by the card holder
- The bank will pay an amount owed by the card holder to any party accepting the card as a payment by the card holder
- The bank has absolute right against the reimbursement by the card holder.

- Credit Card:
  - The card provide revolving credit facilities with limit in credit and period which is set by the issuer
  - The card holder can use the card as a mean of payment of goods and services
  - The card holder is granted a free credit period within which the payment must be made without any chargeable interest. The interest will be charge if the credit period has been due.
- The rule for each card:
  - Debit: no interests are involved and the funds are available in the holder account.
  - Charge card: the card must have a provision as contingencies from the card holder; the card must not be used for haram transactions and must not bear interests.
  - Credit card: the card must not be interest bearing in granting revolving credit facilities.

3. Default in Payment of debt: the scope of this default is the default on part of solvent debtor and guarantor, the definition of default is payment by unlawful (haram) means, and it is prohibited to stipulate any compensation as a penalty clauses for the delay of repayment, the allowable stipulation are only applicable in the installments, in which the outstanding installment can become due within the time of two weeks or more. In

the case of the guarantor, the creditor can settle the debt with the guarantor without seeking the debtor for payment.

4. Settlement of debt by set off: the standard will only be applicable on the debt settlement by set-off and not on any other way (transfer, waive, etc.). set off is a discharge of receivables against payables there are 2 set-off:
    - Mandatory: happens when the set off happens without any bilateral agreement or consent of both parties, the applicable case is if both parties is a debtor and creditor simultaneously.
    - Contractual set-off: happens when the discharge is with mutual consent from the two parties and as the set off does not violate rule of Sharia.
5. Guarantees: this standard covers the guarantees which secure debt and obligations to protect it from the risk of becoming uncollectible debts. It is only permitted in the sales contracts and becomes null in the case of compensation for property destruction. This standard also covers the personal guarantee in the case of sale of goods from a firm to individual.
6. Conversion of Conventional bank to Islamic: this standard covers the process and mechanism of conventional bank conversion to Islamic Bank. This includes the permissible transactions (include the sharia contracts and zakat) and unlawful transactions disposal (include interest and earning from bonds) which the bank can do in their business. This conversion also includes the formation of Sharia supervisory board.
7. Hawala: this standard covers the transference of debt from debtor to another person. This does not include banking remittances. It is a legitimate contract which is made for payment facilitator. The hawala must have the involved parties (debtor, payer and the creditor) consent to be valid.

8. Murabaha to the purchase ordered: this standard is applicable to the stages of murabaha contract (especially the ordered side) and any issues regarding guarantees related to the murabaha contract. This standard is not applicable in deferred payment sales contract.
9. Ijarah: this standard is valid for operating lease of properties, whether the lessor or the lessee. This standard cannot be applied in the labor contract.
10. Salam: this standard is applicable for transactions related to the Salam bonds. It is not applicable to the istisna contract (manufacturing). Salam contract is a contract regarding sale of commodities in a period of time.
11. Istisna: the standard deals with manufacturing of construction. It is applicable in case of the institution as a purchaser or manufacturer. Istisna contract is a binding contract which is bound by time limit of manufacturing.
12. Sharika: these standards deals with partnership and joint venture (include the corporation type of partnership) which are bound by a contract. It is not applicable for regulatory policies and market operations
13. Mudaraba: These standards can be applied in the Mudaraba contracts (mudharaba is a partnership in which one party provides capital and other give their efforts for the business. This standard is not applicable for sukuk and other partnership contracts.
14. Documentary Credit: this standard deals with documentary credit given by an institution on the basis of customer order of for the institution's use. A documentary credit is a written undertaking by the issuer which is given to a seller on behalf of client to purchase certain goods. The procedures of such credit are:
    - Credit contract conclusion: this include the agreement of stipulated price between the seller and the intermediaries

- Request of credit opening: the request are sent by the buyer to the bank to notify the seller
- Credit issuance: the documentary credit is sent to the buyer, while the seller is notified on the credit existence.
- Credit execution: the related parties will present the credit document to the bank, which the bank will examine for the credit condition conformity. If the condition conforms to the instructions, the bank will accept the credit stipulation, if not; the bank can reject or request revision of the documents.

15. Commercial Papers: the standard covers the commercial papers which are conforming with the Geneva Uniform Convention on Law of Commercial Papers (include bill of exchanges, promissory note and cheque) and does not cover any document other than the mentioned three.
16. Investment Sukuk: the standard applies to investment sukuk (certificates of equal value which represent ownership off asset) include the leased asset sukuk, services, mudaraba, musharaka, etc. this does not apply in the case of joint stock shares, certificates of funds and portfolios.
17. Loan: this standard applied to loans and benefits from it and does not apply in the non-loan (e.g. price in credit sales). A loan/qard is a transfer of ownership in assets to a person who is bound to return them in a period/ give similar asset as return.
18. Commodities: this standards applies to contract involving international commodities trading and does not apply in commercial and financial papers, it also does not apply in sales in unorganized market. International commodity sales that are covered is the contract which is concluded in an organized market which are supervised by a specialized institution and distribute through intermediaries in the process of sales and purchases demand contracts only. There are 3 kinds of commodity sales contract:

- Spot contracts: contract which needs immediate delivery and acceptance. The limit of acceptance is within one/two days after transaction
- Forward contract: contract in which exist the deference of delivery and acceptance of commodity. The transaction of delivery will be done at a determined future.
- Future commodity contract: contract which legal effect activated in a determined future date (through cash settlement or liquidation) these contracts seldom become an actual delivery and possession process.

19. Financial Papers (shares and bonds): this standard applies to shares and non-interest bearing bonds in general. It also governs the interest bearing financial papers only in issuance and sale of these bonds which is prohibited by the Sharia. The standard does not govern sukuk.
20. Concession Contract: this standard governs the concession contract for construction, utilization and management of project. A concession contract is a contract that grant the right to a party to utilize project that are agreed upon consideration, the project deals with:
    - Utilization of minerals: deals with the extraction and production of minerals which become a legal body right which is granted by the government.
    - Construction project: a contract that deals with construction of special project (usually public utilities) in behalf of the government.
    - Management concession: deals with the management of public utility and provide service to the public at a price.
21. Agency: this standard deals with agency and the act of uncommission agent in dealing with contract in financial transactions. Agency is an act of delegation of tasks

22. Syndicated Financing: the standard deals with the syndicated financing operation; it is the participation of institution in joint financing operation through Sharia financing.
23. Combination of Contract: this standard covers transaction that consisted of the combination of different contracts. The combination of contract can be formed by:
    - Combining more than one contract without imposing any of their conditions
    - Combining more than one contract while imposing some of their conditions
    - Combining more than one contract which subject to prior agreement
    - Agreement to conclude contract through any form which will be decided in the future.
24. Insurance: this standard discusses all aspects of private Islamic Insurance services. While excluding the public insurance scheme developed by the government. There are two kinds of insurance in Islam:
    - Property: This deals with the damage done to any property of a person which is caused by natural disaster.
    - Person: deals with the risk of disability and death of persons.
25. Banking Services: this standard cover banking services excluding the lending and borrowing process (e.g. informational services and deposit). The standard does not cover loan and investment service rendered by the bank.
26. Arbitration: this standard covers the arbitration as practiced in financial transaction and other situation related to institution and their client. Arbitration is a type of agreement which happen when the disputed parties designate an external party to decide a binding solution for dispute settlement.
27. Zakat: this standard covers the zakat base identification for institution, its calculation, allocation and how to report the Zakat funds in the financial statement.

28. Impact of Contingencies: this standard covers the contingencies which are met during the process of honoring commitment of Islamic based financing. A contingent incident is a sudden incident which causes significant effect to the commitment proper stipulations.
29. Credit Agreement: the standard can be applied to credit facilities; its return and commission arise from them. Term credit is an indebtedness of a party to another party; the term credit can be in form of loans and cash liability. There are two credit facilities that can be granted by an institution:
    - Cash facilities: includes the transactions which require the institution to present funds to fulfill a contract based transactions.
    - Incidental facilities: include the transactions which result in incidental commitment owed by the institution (sponsorships and guarantee).
30. Online Financial Dealing: the standard cover the ruling related to conclusion of online financial contract, its launching, time determination, and protection.
31. Profit Distribution: this standard deals with profit distribution schemes which are the result of mudaraba contract. The standard does not cover the investment through proxy. The investment account includes:
    - Investment account which are managed in unrestricted mudaraba: these are the amount which has no restriction of use (not intended for specific project)
    - Investment account included in restricted mudaraba: amounts which are restricted for specific projects, the profit are shared between the parties involved.
    - Equality in Investment opportunities: the equality of in investment opportunities must be ensured between the shareholder and the investor in participatory mudaraba.

32. Islamic reinsurance: thee standard covers the process of reinsurance and its participation by the insurance company. While exclude the Islamic insurance process. An Islamic reinsurance is a process of agreement between the insurance companies to provide reserve for partial avoidance of potential risks which the firm might encounter in their business. It is a donation basis payment for mitigating risk of insuring a client risks.

Source: (Accounting and Auditing Organization of Islamic Financial Institution, 2010)

While in Indonesia the generally accepted accounting standards which is developed by the Indonesian Accountant Association (Ikatan Akuntan Indonesia/IAI), also called PSAK (Pedoman Standar Akuntansi Keuangan). The standard which was first made and become sole standard for sharia financing process is the PSAK 59 about sharia financial accounting; it governs all financing mechanism of a sharia institution (mudaraba, istisna, musharaka, Salam, ijara and murabaha) and covers all reporting and disclosure of financial information. The standard is only governs the sharia banks and micro banks (Ikatan Akuntan Indonesia, 2002).

The standard number 59 is then replaced by the new standards, which are:

1. PSAK 101 which cover the basics of sharia financial report preparations which covers the basic definition of sharia financial report (a structured report which shows the financial position of a sharia institution). This standard also explains the purpose and the elements of sharia financial reports (which are similar to the conventional financial report, with addition of zakat and social funds reporting). This standard is enacted in 2011 and was revised in 2014 (Ikatan Akuntan Indonesia, 2014).
2. PSAK 102 covers the murabaha related accounting principles, the standard govern the mechanism of murabaha financing only from the seller's perspective, it first

govern only the sales transaction with the base of risk and reward (2007) the revised standard govern the financing murabaha (including the sales murabaha) which are linked to the PSAK governing the annuities (50, 55 and 60) and add the return on the effective result. PSAK 102 was first developed on 2007 and was revised on 2013 (Ikatan Akuntan Indonesia, 2013).

3. PSAK 103: this standard governs the sharia transaction of Salam (deferred sales contract) from the perspective of both seller and buyer and does not cover the accounting treatment for sukuk which use Salam contract. The standard is enacted in 2007 (Wiroso, 2011).
4. PSAK 104: this standard covers the istisna (manufacturing) and parallel istisna transaction done by the related parties (financial institution, entrepreneur) it also include the profit and cost sharing schemes for the said transactions. The standard is enacted in 2007 (Ikatan Akuntan Indonesia, 2007).
5. PSAK 105: this standard covers the Accounting related to Mudaraba transactions. Mudaraba is a contract in which the related parties agreed to provide capital and effort (each party contribute one of the elements), this standard govern the profit sharing and all types of mudaraba (*muthlaqah*: freedom for the manager of funds, *muqayyadah*: limited management of funds, and *musytarakah*: the manager contribute his capital as a joint investment). The standard is enacted in 2007 (Ikatan Akuntan Indonesia, 2007)
6. PSAK 106: This standard covers the accounting which related to the Musharaka transaction. A musharaka is a joint venture investment contract and does not include the accounting treatment of sukuk which use musharaka contract there are 2 kinds of musharaka:
   a. Permanent Musharaka: musharaka which are predetermined and has constant amount of investment share until the contract conclusion

b. Derivative *musharaka*: *musharaka* which funds share of one party will decline gradually so that the other party will have the business in full.

The standard also governs the accounting treatment over the parties (both active and passive). It was enacted in 2007. (Mediawati, 2007)

7. PSAK 107: this standard govern the Ijara accounting, including the multiservice financing which use ijara scheme excluding the sharia bond (sukuk) with ijara contract, ijara is a contract of right transference on the utilization of asset within a determined period and a lease payment without any transfer of ownership of asset and risks. There are 2 kinds of ijarah:
   a. Ijarah muntahiyah bittamlik: ijarah with promise (wa'ad) of ownership of asset transference in a determined period.
   b. Bargain purchase lease: an ijara with an option of purchase on a bargained price, this lease can be sold to the lessee after the leasing period is expended.

Source: (Ikatan Akuntan Indonesia, 2008)

8. PSAK 108: this standard cover the settlement of murabaha based loans and liabilities from the perspective of both buyer and seller in a sales contract. Excluding the accounting treatment for bad debt and its estimation.

Source: (Ikatan Akuntan Indonesia, 2008)

9. PSAK 109: this standard covers the regulation of accounting treatment for zakat and infak/donations and does not govern the entities which do not receive and distributing zakat as its primary activities (these entities are governed by the psak 101 about the sharia financial reporting. Zakat funds are a fraction of obligatory alms giving, while infak is the voluntary alms given to the poor people (mustahiq).

Source: (Ikatan Akuntan Indonesia, 2008)

10. PSAK 110: this standard cover the hawala related transaction which is done by the financial institutions (bank, insurance and other financial institution). A hawala is transference of debt from a person to the other. There are 2 kinds of hawala:
    a. Hawala muqayyadah: is a hawala where debtor has debt and receivables to the third party.
    b. Hawala muthlaqah: hawalah where the debtor does not have any receivables to the third party.

Source: (Ikatan Akuntan Indonesia, 2008)

11. PSAK 111: This standard governs the aspects of Sharia insurance, including the surplus and deficit from the underwriting process and *tabarru* funds reserve. It govern the sharia based insurance entities (include: life insurance and reinsurance) and exclude its scope within the general financial reporting, not covering the statutory reporting for regulatory body or sharia supervisory board. *Tabarru* fund is reserves developed from the underwriting retained surplus which is used for covering potential future deficit.

    Source: (Ikatan Akuntan Indonesia, 2008)

Sofyan (2012) state the distinguished differences between the PSAK 59 and 101 to 106 are:

PSAK 59	PSAK 101-106
Sole standard	6 standard in existence
Govern sharia banks (micro banks and sharia general banks)	Govern both sharia and conventional entities
There is no purpose of financial report	Purpose of financial report: • Compliance

	• Accountability • Social
There is no measurement method	Measurement method: • Historical value • Current value • Net realizable value
There is no related party regulation	Regulate the sharia related parties

Table 2.1: PSAK Difference

Source: (Harahap, 2012)

A bank is financial institution which are licensed to receive deposits (investopedia)

Islamic Bank is a financial institution which provides the financing and banking service for the society it acts as an intermediary between the investor and borrower. The sharia banks operates on the basis sharia principles (with the most prominent one is the abolishment of interest/riba, which are considered as haram by the Quran) (Ajlouni, 2012).

Sharia Business Unit (UUS/BUS) is a unit of a bank which has the functionality as an intermediary to sharia based transactions. It operated under Islamic principles. (Bank Indonesia, 2008)

The Quran acknowledge riba as increase/excess, this excess is considered as usury therefore it is forbidden. There are 2 kinds of riba, they are:

1. Nasi'ah: is the excess expected by a creditor from granting delay in repayment of debt this kind of riba is forbidden by the Quran.
2. Fadl: is the excess charged in sales transactions, this kind of riba is forbidden by the Sunnah

Furthermore, Ibnu Hajar (2014) state two additional type of riba which are:

1. Qardh: excess gained by conditions which are set by the creditor to the debtor.
2. Jahiliyyah: excess which arise because of the inability of a debtor to fulfill his debt on the predetermined time

(Hajar, 2014)

According to Obada (2008) the prominent elements of Islamic bank definition are:

1. Islamic bank, just like conventional bank, act as financial intermediaries.
2. Islamic bank operate on the basis of Islamic laws, they still provide service like current account savings and deposits.
3. The Islamic dimension in gaining and expending the resources distinguish the Islamic banks and conventional banks
4. The Islamic main objectives are the development of economy and fairness within the society (Obada, 2008)

The Islamic banks source of funds are divided into 2, they are:

1. Internal resource: include the paid in capital and retained earnings.
2. External resource: include deposits, bonds, charity service and grants (Ajlouni, 2012)

Unlike Conventional banks which use their funds for securitization, Islamic banks use the funds for the following:

1. Musharakah (Joint Venture): is an agreement between the bank and 2 or more parties for a business purpose, the capital, potential risk and benefit will be shared on a predetermined percentage
2. Mudarabah (Venture Capital): is a contract between Islamic banks and a party (commonly an entrepreneur) in which the bank provide the capital for the

entrepreneur to do the business. The profit sharing is similar to musharakah, the difference is that in mudarabah, the loss is bore by the banks

3. Murabahah (Cost Plus): is a sales contract in which the seller and his client agree on sales cost and profit, in sharia bank, the bank act as the intermediary for this transaction and take the known cost plus for their profit.
4. Leasing (Ijarah) is a contract to take advantage of renting the right to utilize a non-consumable item, in Islamic banks there are 2 kinds of leasing contract: *lease contract*; in which the leased asset will be returned to the owner after a predetermined period and *lease to own contract*; in which the leased assets can be bought by the lessee through gradual purchasing process
5. Manufacturing (Istisna): is a sales contract for manufacturing infrastructure for public, which expected to be manufacture in a near future, the sharia bank use this financing commonly for construction of their projects (Hassan, 2007)
6. Irrigation: is a partnership contract which deals with irrrigating and gathering fruits of a tree, this agriculture contract returns will be shared equally between the owner and the labor.
7. Farming and Implanting: is financing for agriculture, it could be in form of partnership contract between two or more parties. The contract deals with the providence of seeds, land and labor cost to cultivate a farm, the output of the farming operation will be shared between involved parties in specified shares. This contract is a short term contract.

Source: (Omari, 2010)

The Islamic banks intermediation are different from conventional banks intermediation, the Islamic banks perform intermediation through risk sharing and asset based financing, while conventional banks do it through risk transfer and debt based financing. As Maher and Jemma (2010) explained in the following table:

Risk Sharing and Risk Transfer	
Islamic Banks Risk Sharing	Conventional Banks Risk Transfer
Source of funds: investors (profit sharing account holder) the profit sharing returns highly depending on banks performance.	Source of funds: the risk transferred from depositor is guaranteed by a specified return
Use of funds: risks are shared in Mudharabah and Musharakah contracts, the banks also share the risk in the sales contracts	Use of funds: The banks transfers the risk through securitization and credit default swaps

Table 2.2: Risk Management in Commercial and Sharia Banks

Source: IMF Working Papers, (Dridi & Maher, 2010)

According to Sharia Banks generally conduct 3 categories of services which are:

1. Free services: services provided by Islamic Banks without any charge for the customers, this includes providing information about accounts, etc.
2. Fixed fee services: these are services in which the bank charge a fixed commission/fees in rendering them, some of the include:
    - Deposits: Islamic bank can accept deposits from the customer (including the valuable properties, documents and important papers which are safer to be deposited in the bank), the bank can charge a fee for related services
    - Transfer: bank transfer could be in form of cheques (wadiah), bank drafts, letter of credit (L/C) and other monetary receipts.

- International trade: in providing this service the bank become agents of the beneficiary customer, the bank can open L/C, process the required documents and make cash inflow and outflow for the need of export and import trading.
- Purchasing fixed assets: The bank can purchase a fixed asset for the customer, the commission can be charged by the bank for necessary legal process in acquiring the assets.
- Advisory services: The Islamic banks can provide expert service (consultancy) in procurement and expanding business to its client and charge the consultant fee
- Investment on behalf of customer. the Islamic banks can also purchase shares for clients using the customers fund with their consent, the dividend/profit being made are returned to the customer as the shares and funds are kept.

3. Creation of capital: these are service that the banks do to provide returns for their customers and investors

The source and use of funds by Islamic Banks are further showed in the following table

Source of Funds	Use of Funds
1. Internal equity 2. Deposit } Total Funds a. Current Account	1. Deployment of Funds a. Qard al Hasanah • Overdraft • Cash credit application • Demand Loan • Priority sectors, individuals and

	the poor
b. Profit-Loss Sharing Accounts (PLSA)	b. Profit Loss Sharing Investments • Equity Financing • Leasing • Hire Purchase • Normal Rate of Return c. Direct Investment by Banks • Bank projects • Investment auctioning • Commodity trade • Spot foreign exchanges (forex) transaction • Bai Muajjal • Bai Salam • Discounting Equity
3. Special a. Za b. kat c. Social welfare funds	2. Zakat a. Charity to target group b. Project for target group.

Table 2.3: Sharia banking financing instrument

Source: (Mosab, Sadeq, & Mallick, 2006)

In Indonesia, the idea of sharia banks are first conceived in 1991 by Muslim scholars, the implementation and development of Islamic banks is started with the development of bank Muamalat Indonesia by the Majelis Ulama Indonesia. The development is then supported by the Central Bank after the major financial crisis hit Indonesia in the period during1997-1998. After the crisis, Bank Indonesia develops dual banking system and encourages the conventional banks to develop their sharia business unit. (Bank Indonesia, 1999)

The Indonesian Islamic Banks have several terms that must be fulfilled in order to operate in Indonesia:

1. The owner of the sharia bank must be Indonesian (individual or corporation)
2. The bank must attach the "bank syariah" phrases in its name
3. The bank must have a license from Bank Indonesia (whether as Sharia Commercial Bank or as Sharia Business Unit)
4. The bank must have a license from Bank Indonesia to open additional branches
5. The banks' legal entity must be Limited Company (PT)
6. The conventional banks which want to be converted to Islamic banks must first develop a Islamic Business Unit (BUS)

There are also controlling actions that Bank Indonesia can take in order to bail the risky sharia banks:

1. Limits the authority of shareholder general meeting
2. Requests the additional capital from the shareholders
3. Requests replacement of BOD and BOC members
4. Requests the closing of bad funds and its loss to the sharia banks
5. Liquidates the sharia bank which is default

6. Provides assistance the sharia bank in merger and acquisition process

Source: (Bank Indonesia, 2008)

According to Otoritas Jasa Keuangan (2015) there are 12 Islamic Banks which operate in Indonesia, they are:

1. Bank Muamalat Indonesia
2. Bank Victoria Syariah
3. Bank BRI Syariah
4. BPD Jabar Banten Syariah
5. Bank BNI Syariah
6. Bank Syariah Mandiri
7. Bank Syariah Mega Indonesia
8. Bank Panin Syariah
9. Bank Syariah Bukopin
10. Bank BCA Syariah
11. Maybank Syariah Indonesia
12. Bank Tabungan Pensiunan Nasional Syariah

And the banks which have Sharia business unit are the following:

1. Bank Danamon Indonesia
2. Bank Permata
3. Bank International Indonesia
4. Bank CIMB Niaga
5. Bank OCBC NISP
6. Bank DKI
7. BPD Yogyakarta

8. Bank Pembangunan Daerah Jawa Tengah
9. BPD Jawa Timur
10. BPD Jambi
11. BPD Aceh
12. BPD Riau
13. BPD Sumatera Selatan and Bangka Belitung
14. BPD Kalimantan Selatan
15. BPD Kalimantan Barat
16. BPD Kalimantan Timur
17. BPD Sulawesi Selatan dan Barat
18. BPD Nusa Tenggara Barat
19. Bank Sinarmas
20. Bank Tabungan Negara

The following is the prominent differences between Islamic Banks and Conventional Banks:

Islamic Banks	Conventional Banks
1. No Interest involved in transaction, depositor receive share of profit 2. Risk are shared	1. Interest is part of operation and crucial for banks profitability 2. Risk are transferred

Table 2.4 Difference between Sharia and Conventional Banks

Furthermore Arif Wibowo (2012) states there are 10 advantages in banking with sharia banks, they are:

1. Spiritual Blessings (al-barakah): the depositor who deposits in the sharia banks (especially in mudharabah system) will be blessed by the God. Since all deposits in mudharaba are based on profit sharing, it will not become an unlawful transaction for

the God, the abolishment of interest will also saves the bank from financial crisis because of interest rate.

2. Worldly and Heavenly profit (Al Falah fid Dunya wal Akhirah): the depositor who saves their money in Islamic Banks will get return from profit shared by the bank, while at the same time avoiding sin from receiving riba.
3. Live Muslim (Islam Kaffah): Islam believers are encourage to live as a true Muslim in every aspect of their lives, this includes how they perform their daily economic transaction, by banking with the Islamic Banks, the believers lives are according to the sharia laws
4. Worship (Al ibadah): implementing sharia economic value with intent is considered as a lawful (halal) and act as a tool for worshipping the God
5. Assisting in human development (Irtifa'u iqtisadil Ummah): Islamic banks help the believers in developing and expanding their business so that their welfare can be sustained.
6. Institutional development (Irtifa'u Ma'hadil Islami): on the other hand, the institution will be able to avoid their bankruptcy and liquidation by the help of these believers.
7. Avoiding the unlawful business financing (Amar ma'ruf nahi munkar): the sharia banks highly avoid the financing in unlawful business (e.g. gambling, intoxicating beverages, etc.); the banks only finance the halal business.
8. Safety and security of funds (Al- Amnu wad Dhaman): the resistance to collapse of the Islamic banks are proven in the 1998 crisis, the depositor will have no worries in depositing their money in the Islamic banks, because along with the resistance, the bank has also been backed up by the LPS (*Lembaga Penjamin Simpanan*)

9. Sustaining the national economy in crisis period (Inqazu iqtishadit Daulah): the no interest value of Islamic Banks are the reason that the crisis have less severe effect to these banks, the interest will only cause deficit in the national reserve.
10. Economic welfare (irtifa'u Tarbiyatil Muslimin): the final objective of Sharia banks is the development and distribution of economic welfare to all layers of society. This welfare will boost other aspect of the society so that they can advance to the new level of quality of life.

Source: (Wibowo, 2012)

The following table summarizes the phases of sharia bank development initiatives done by BI:

	Placing strong basis for sustainable development (2002-2004 period)	Strengthening industrial structure (2004-2008)	Complying with informational standards for financial product and services (2008-2011)
Compliance to sharia principles	• Promoting better understanding of sharia financial concept • Supporting formulation of sharia financial norms • Conducting studies for regulatory and supervisory integration	• Supporting more efficient sharia supervising effort • Developing incentive for compliance to sharia improvement	• Realizing sharia and financial aspect rating systems.
Prudential set of policies	• Improve foundation	• Developing risk	• Promoting the

	for good governance and regulation • Improving network policies • Developing feedback mechanism for regulations • Implement real time supervision	based policies and control • Developing entry and exit policies	foundation of self-regulatory system
Operational efficiency and competitiveness	• Supporting economies of scale and scope • Supporting human resource development • Develop cooperation with related institution • Develop sharia arbitrage organization	• Facilitating strategy cooperation • Founding cooperation with supporting institution.	
Systemic stability and economic benefit	• Advocate the establishment of sharia finance information center • Conducting systemic cost analysis • Study advantage of	• Increasing the role of sharia financial information centers • Supporting the involvement of rating agencies • Study the voluntary	• Supporting the realization of integrated sharia financial systems

	sharing contracts implementation	sectors • Facilitate the use of share based financing	

Table 2.5 Phases of Sharia Implementation by the Central Bank

(Bank Indonesia, 2002)

Theoretical Framework

Data Envelopment Analysis is a technique for efficiency measurement of complex entities which have many inputs and outputs. This was first developing by Charnes, Cooper and Rhodes in 1970. This method was first used for the purpose of evaluating the efficiency of educational programs for students. This method of analysis is using several or many Decision Making Unit (DMU) as input/output for measuring the efficiency of the decision. With basic formulas as the following:

$$maxh(u, v) = \frac{\sum_r uy}{\sum_i vx}$$

U= weight of output k

V=weight of input k

Y=amount of output k from DMU

X=amount of input k from DMU

(Cooper, Seiford, & Zhu, 1990)