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DETERMINANTS OF ISLAMIC BANK PERFORMANCE IN INDONESIA

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ABSTRACT

Islamic banking industry in Indonesia still has limited market share, around 6.52% of the total market share of the banking industry, while the conventional bank is 93.48% at the end of 2021. This study aims to determine the factors that influence Islamic Bank Performance in Indonesia. This study adopts quantitative methods where secondary data was collected from the annual Islamic Banking financial statements for the period 2017 to 2021 obtained directly from the official website of each bank and Indonesia Financial Services Authority. The data collected was analyze using SPSS. The results of regression analysis indicate that asset quality and liquidity significantly leads to the negative Islamic bank's financial performance of ROA, whereas capital adequacy positively contributes to the Islamic bank's financial performance of ROA. Unfortunately, the findings reveal that gross domestic product and inflation have no association with Islamic bank's financial performance. This research also includes a discussion, limitations, recommendations and conclusion.

Keywords: *Islamic bank, bank performance, profitability, return on asset, indonesia*

I. Introduction

Overview of The Study

A bank defined as a financial institution whose activities of its business is to collect funds from the community and returns them back to the community, in addition to providing other financial services. The role of a financial intermediary, which refers to an institution that links and bridges money providers and clients, is fulfilled by the banking system, which is one of the financial systems. As a result, bank operations must be efficient on both a macroeconomic and microeconomic scale.

Conventional banks and Islamic banks are two distinct categories of financial institutions that can be differentiated by the nature of their business activities. A conventional bank is one that conducts its business activities conventionally, an Islamic bank, on the other hand, is one that performs its banking activities in accordance with the principles of Islamic law. The Islamic financial industry is becoming more visible and established as time passes and the financial sector advances. Today, Islamic finance has become a major player in global finance. The size of the number of financial institutions, the amount of their assets, and the size of the client base on the kind of financing demonstrate the ongoing expansion of Islamic finance. Due to an intense competition that exists between conventional banks and Islamic banks in Indonesia, Islamic banks are expected to have strong performance in order for them to be able to compete for the national banking market.

One of the performance assessments that can be carried out is to assess financial performance, because financial performance provides the quality of a bank through the calculation of its financial ratios. The assessment of financial performance is one method that management may use to accomplish its commitments to stakeholders while simultaneously achieving the aims outlined by Islamic banking. The information presented in the financial performance can be used by related parties, both investors, creditors, and banking external parties to predict the actual financial performance at any period

There are various financial performance indicators that essentially indicate the bank's performance in carrying out its activities. Financial indicators that commonly used to measure the performance of Islamic banks such as capital adequacy ratio, non performing financing, and finance to deposit ratio. While profitability indicators can usually be measured by indicators of return on assets, return on equity, and the total assets. Besides that, Islamic bank performance is also can be affected by external factors. External factors related to macroeconomic conditions in the business activities of Islamic banks include the development of economic growth rates and inflation rates. In addition, macroeconomic conditions that can have an influence on bank profitability is the inflation rate.

Problem Statement

The Development of Islamic banking in Indonesia is quite rapid as it can see based on the Sharia Financial National Committee (KNKS) at the end of 2022 there have been 13 operating sharia commercial banks, 22 Islamic business units, and about 1500 different rural banks located in Indonesia. However, data published by the Islamic Financial Service Board/IFSB (2022) states that the average growth trend for Islamic banks globally shows a fluctuating decline from 2017 to 2021 in terms of assets, financing and deposits. This was also supported by Indonesia Financial

Services Authority publications on financial ratios as measured by ROA and NOM, the financial performance of Islamic banking still fluctuating from 2017-2021.

And while having been in operation for the past three decades, this quick development has not yet been successful in reaching the market share target. According to the data obtained from official website of Indonesia financial services authority, Islamic banking industry in Indonesia still has a limited market share, around 6.52% of the total market share of the banking industry, while the conventional bank is 93.48% at the end of 2021. Although Islamic banking industry exhibits relatively significant growth for the last two decades, the market share of this industry never reaches the expected target of 20%, whereas the conventional banking industry, at the same time, also enjoys considerable growth. Considering that the importance of the function and role of Islamic banks in Indonesia, banks need to improve their performance.

Significance of Study

The findings of this research will be beneficial in bringing to the attention of managers working in Islamic banks in Indonesia the importance of recognizing these factors, which may either directly or indirectly affect the performance of banks. Additionally, to enhance the economic competitiveness of Islamic banks in Indonesia. The information that was gathered as a result of this study may also be utilized by investors so that they can base their investment choice on the financial performance of Islamic banks.

II. Literature Review

Return on Asset

Factors influencing bank profitability can be sourced from various profitability performances shown by several indicators. Return on assets (ROA) is an essential profitability indicator for banks (Amir et al., 2022). Return on assets (ROA) is a ratio that assesses a company's efficiency in managing its assets to create profits over time (Choiriyah et al., 2021). The return on assets (ROA) shows the amount of profit generated in relation to the bank's total assets and displays the management's ability to make profitable use of the bank's financial and physical resources. Its serves to evaluate how effectively businesses are able to generate profits by making use of the resources at their disposal. When a bank has a higher ROA than its competitors, it may make better use of its resources, which in turn will increase its profits. (Yusuf & Surjaatmadja, 2018). Because of this, ROA is often considered to be the most accurate measurement of efficiency.

Asset quality

The survival rate of the bank’s business is closely related to the productive assets it holds, therefore the bank management is required to be able to constantly monitor and analyze the quality of the production assets that it owns. The quality of productive assets indicates the quality of assets in relation to the credit risk faced by the bank as a result of the granting of loans and investments from the bank.

Asset quality may be defined as credit or non-performing financing when the debtor is unable to fulfil the payment of loan arrears within the agreed-upon term in the agreement (Yusuf & Surjaatmadja, 2018). It shows the financing risk obtained by banks caused by the investment/financing of bank funds in different portfolios (Ichsan et al., 2021). The nonperforming financing ratio is used to assess a bank's capacity to manage problematic loans provided by the

bank. The credit risk accepted by the bank is one of the risks of the bank's operations resulting from uncertainty in its repayment or that is due to the failure to repay the credit provided by the Bank to the debtor. It represents financial risk; the greater this percentage, the poorer the quality of sharia bank funding (Yusuf & Surjaatmadja, 2018). As a result of the huge number of troublesome financing, this might, of course, result in a loss of chance to make money from financing supplied to effect profits and acquire a negative impact on return on asset.

Capital Adequacy

According to the definition provided by the Central Bank Regulations, capital adequacy is the result of dividing main capital into the total of risk-adjusted assets on risk factors in percentage. This division produces a number that represents the level of capital that is adequate. The capital adequacy ratio is a tool that bank management and investors use to evaluate the amount of risk associated with a bank's ability to pay off past due loans (Sang, 2021). In addition, it establishes a bank's ability to satisfy short-term obligations while simultaneously dealing with other risks such as market risk, operational risk, credit risk, and other (ALNAJJAR & Abdullah Othman, 2021).

In Malaysia, (ALNAJJAR & Abdullah Othman, 2021) conducted a study on the influence of capital adequacy ratios on the performance of Islamic banks in selected MENA countries. The results of the study indicated that the Islamic financial institutions that were chosen to participate in the research are dedicated to the capital adequacy ratio (CAR). Capital adequacy has a significant positive effect on return on asset in sharia commercial banks in Indonesia, an increase in capital adequacy will also result in an increase on return on asset. With high capital banks can flexibly to put their funds into profitable investments so that it can improve customer confidence because of the possibility of banks get a high profit (Yusuf & Surjaatmadja, 2018).

Liquidity

Another variable that is used to determine the performance of a bank or the health of a bank is the liquidity/financing to deposit ratio (Amir et al., 2022). It measures a bank's liquidity position. The greater the loan amounts are in comparison to deposits, the lower the liquidity level (Stephen Kingu et al., 2018). Financing to deposit is a ratio used to analyze the amount of bank liquidity, with the goal of determining the bank's capacity to satisfy financing demands based on total assets owned by the bank (Harjanti, 2021). The excessively high levels of financing to deposit ratio will cause the lower level liquidity of Islamic banks (Sitompul & Nasution, 2019). Financing to deposit ratio gives an overview of Islamic banks' optimization to promote the real sector, because the higher the financing to deposit ratio, the more optimum Islamic banks are in channeling deposits into banks in the form of financing for the real sector (Risalah et al., 2018).

Gross Domestic Product

Gross Domestic Product is a macroeconomic indicator that also affects bank profitability. Gross domestic product is described as one of the macroeconomic indicator most commonly used to calculate overall economic activity, which can impact a variety of factors in both the demand and supply of banking services. If gross domestic product rises, it will be followed by an increase in public income so that the ability to save also increases (Istan & Fahlevi, 2020). The gross domestic product is projected to have an influence on a number of variables linked to loan and deposit supply and demand. Favorable economic conditions will change the demand and supply for financial services, altering profitability either positively or negatively (Setyawati et al., 2017). (Usman and Lestari, 2019) Explain how the gross domestic product growth rate leads to increased

public consumption, which raises demand for bank loans. Credit interest will benefit the bank as the demand for credit grows.

Inflation

Inflation is a broad pricing situation in which both products and services prices rise. Inflation impacts the underlying value of expenses and revenue, but it can have an influence on profitability either positively or negatively, depending on whether inflation is predicted (Setyawati et al., 2017). Inflation reduces the amount of money in circulation, although this is partly attributable to the government's monetary policy enforced through the central bank. The government regulates money circulation in such a manner that it impacts the process of producing money (Istan & Fahlevi, 2020). This could adversely affect a bank's profits and performance.

Inflation has a negative influence on the economy because it reduces public interest in saving and investing, as well as the motivation to create. Inflation raises prices, which is very harmful to the community because it makes it difficult to meet the rising prices of daily necessities. Inflation is also very harmful to businesses because it raises production and operational costs, resulting in a decrease in bank profits (Fuadi et al., 2022). Inflation has a lot to do with the welfare of banks because banks deal in nominal financial products, which are units of currency. For example, when a bank makes a loan to a borrower, both parties specify a fixed amount to be paid in the future. However, as inflation increases over time, the purchasing power of money paid to banks decreases (Fani et al., 2018).

Research Framework and Hypothesis Development

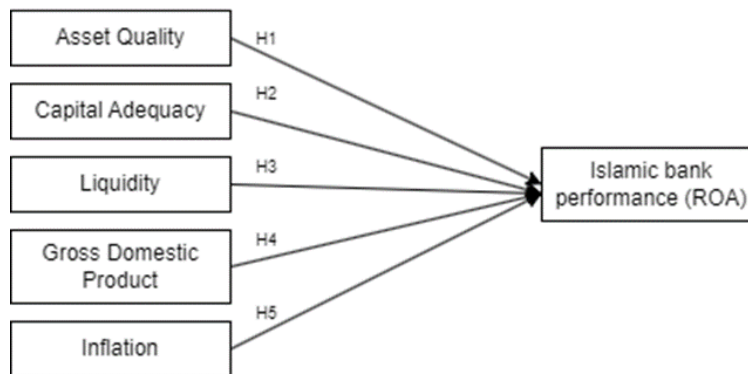

Figure 2.1 Conceptual Research Framework

III. Research Methodology

Population and Sample

There are several banks that implement the sharia system in their operational activities, the population used in this study is Islamic banks in Indonesia that registered with the Financial Services Authority (OJK) and Bank Indonesia which are attached in the table below.

Table 3.1 Islamic banks in Indonesia

No	Islamic banks in Indonesia
1	PT BANK MEGA SYARIAH
2	PT BANK ALADIN SYARIAH Tbk
3	PT BANK VICTORIA SYARIAH
4	PT BANK JABAR BANTEN SYARIAH
5	PT BANK PANIN DUBAI SYARIAH Tbk
6	PT BANK KB BUKOPIN SYARIAH
7	PT BANK BCA SYARIAH
8	PT BANK TABUNGAN PENSIUNAN NASIONAL SYARIAH Tbk
9	PT BANK ACEH SYARIAH
10	PT BANK NTB SYARIAH
11	PT BPD RIAU KEPRI SYARIAH
12	PT BANK SYARIAH INDONESIA Tbk
13	PT BANK SYARIAH INDONESIA Tbk

The sample in this study was obtained using a purposive sampling method based on its features. Purposive sampling method is a way of selecting a sample based on certain criteria. The following criteria used in this study are:

a. Islamic banks are consistently operated in the study period is from 2017-2021.
b. Islamic banks who publish annual reports in 2017-2021.
c. Presents data on return on asset, non-performing financing, capital adequacy ratio and financing to deposit ratio during the period of 2017-2021.

From the total 13 banks that registered in Indonesia financial service authority (OJK) and Bank Indonesia, only 10 Islamic banks that fit the criteria.

Collection of Data

This study uses public records, government publications, historical and statistical documents, collected from bank's financial report and official website.

Research Design

The research design serves as a working framework to ensure that research is carried out properly and efficiently (Choiriyah et al., 2021). Design is advantageous to research implementers as well as to all those participating in the research activity. Based on the definition of the issue and the hypothesis, the research design may be created. The research design used in this study is quantitative descriptive design using hypothesis testing.

Data Analysis

The analysis method used in this study include normality test, descriptive analysis, pearson correlation, and multiple regression, which are aided by the program statistical data processing known as SPSS version 25.

IV. Data Analysis

Descriptive Statistics

Table 4.1 Descriptive Statistics

Variable	Mean	Max	Min	Std. Dev	N
ROA	0.015114	0.1100	-0.0338	0.0377036	10
NPF	0.038796	0.2158	0.0004	0.0673033	10
CAR	0.489126	2.4007	0.1905	0.6769772	10
FDR	187.12219	1863.2192	0.6979	588.92047	10
GDP	0.04614	0.0766	0.0195	0.0170594	10
INF	0.044988	0.0880	0.0206	0.0218871	10

Sources: Researcher, 2023

Table 4.2 provides the descriptive statistics of the internal and external factors that influence the performance of Islamic banks in Indonesia. In average, the return on asset of 10 Islamic banks used in this study is 1.51%. This indicates that the ability of the Islamic Bank in Indonesia to generate income from the utilization of their assets is considered low. The mean of all other independent variables are also positive. As it can be seen from the table, the average non-performing financing is 3.88%, this is positive since a low ratio indicates that the bank's outstanding loans offer less risk. The average of capital adequacy ratio is 48.91%. This shows that the bank is better prepared to deal with unexpected losses due to availability of adequate capital. A bank with a high capital adequacy ratio is seen to be solvent since it exceeds the minimum criteria. As a consequence of this, the capital adequacy ratio of a bank may be used to determine how well it is prepared to weather a financial crisis or other types of unexpected losses.

Meanwhile the average financing to deposit ratio is 18712.22% which is too high. If the percentage is excessively high, it indicates that the banks may not have sufficient liquidity to manage any unforeseen financial requests that. Bank Indonesia regulation states that maximum FDR is 110%, if the value of FDR is below 110%, the FDR is said to be good, and if the FDR is above or exceeds 110%, the bank considered as less liquid because the bank has lent out all of its deposits. And from the table, shows that the average gross domestic product is 4.61% and the average inflation is 4.50% for the past 5 years.

Correlation Analysis

Table 4. 2 Pearson Correlation

	ROA	NPF	CAR	FDR	GDP	INF
ROA	1.00	-0.596 *	0.093	-0.007	0.025	-0.255
NPF	-0.596 *	1.00	-0.251	-0.193	-0.267	0.431
CAR	0.093	-0.251	1.00	0.992**	0.179	-0.368
FDR	-0.007	-0.193	0.992**	1.00	0.171	-0.386
GDP	0.025	-0.267	0.179	0.171	1.00	0.368
INF	-0.255	0.431	-0.368	-0.368	0.368	1.00

Sources: Researcher, 2023

Based on pearson correlation analysis above, the empirical data in Table 4.3 show that non-performing financing has a negative association with bank profitability / return on asset, which is statistically significant at the 5% level of significance. Meanwhile, there is a positive association

between the financing to deposit ratio and the capital adequacy ratio. and its statistically significant at the 1% level of significance.

Regression Analysis

Table 4. 3 Regression Model

Variables	B	Std. Error	t	Sig.
(Constant)	0.056	0.145	0.388	0.718
NPF	-0.019	0.006	-2.955	0.042
CAR	0.213	0.041	5.228	0.006
FDR	-0.061	0.013	-4.666	0.01
GDP	-0.098	0.037	-2.681	0.055
INF	0.059	0.028	2.105	0.103
R square		0.151		
Adjusted R-squared		0.106		
F statistic		3.346		
Significance F		0.008		

Sources: Researcher, 2023

Factors determining the financial performance of Islamic banks in Indonesia that measured using return on assets (ROA) is presented in Table 4.4. The finding reveals the t value is 0.388, coefficient regression (beta) -0.019 with probability of 0.042. Based on the results of data processing where the probability value (p) ≤ 0.05, it can be concluded that non performing financing has a negative and significant effect on return on asset. Meanwhile, capital adequacy ratio has t value of 5.228, coefficient regression (beta) 0.213 with probability of 0.006 which is lower than (p) ≤ 0.05, indicates that the capital adequacy ratio has a beneficial and noticeable impact on the return on asset. Financing to deposit has t value of -4.666, coefficient regression (beta) -0.061 with probability of 0.010 which is lower than (p) ≤ 0.05, means that financing to deposit ratio has a negative and significant effect on ROA. Nevertheless, the findings reveal that asset quality (NPF), capital adequacy (CAR), and liquidity (FDR) are significantly related to the Islamic bank's performance (ROA). Based on the result above, we can conclude that hypothesis 1,2, and 3 are accepted. Asset quality, capital adequacy, and liquidity have relationship with Islamic bank's performance (ROA).

Contrary, gross domestic product has t value of -2.681, coefficient regression (beta) -0.098 with probability of 0.055 which is higher than (p) ≤ 0.05, means that gross domestic product has no significant effect on return on asset. Inflation has t value of 2.105, coefficient regression (beta) 0.059 with probability of 0.103 which is higher than (p) ≤ 0.05, means that gross domestic product has no significant effect on return on asset. This study fails to find any association between gross domestic product and inflation on Islamic bank's performance (ROA). Therefore, according to the result of regression above, it can be concluded that hypothesis 4 and 5 are rejected. There is no relationship between gross domestic product and inflation with Islamic bank's performance.

Summary of Findings

According to the findings, from the descriptive statistic table the return on asset of 10 Islamic banks used in this study is 1.51%. This indicates that the ability of the Islamic Bank in Indonesia to

generate income from the utilization of their assets is considered low. the average value of non-performing financing is 3.88%, This is positive sign since a low ratio indicates that the bank's outstanding loans offer less risk. The average of capital adequacy ratio is 48.91%. This shows that the bank is better prepared to deal with unexpected losses due to availability of adequate capital. Meanwhile the average financing to deposit ratio is 18712.22% which is too high. If the percentage is too high, the banks may not have adequate liquidity to meet any unexpected financial requirements.

V. Discussion and Conclusion

Justification of Research Findings

Asset quality

According to the findings of this research, the asset quality of an Islamic bank's has a considerable and negative impact on the bank's performance / return on assets (ROA). This study is consistent with previous studies conducted by (Stephen Kingu et al., 2018) and (Harjanti, 2021) which asserted that asset quality has a significant negative effect on bank’s profitability (ROA). (Usman & Lestari, 2019) pointed out that asset quality had a significant negative impact on bank performance / return on asset. This means that bank-owned assets cannot absorb losses from both excessive lending, rising costs, the cost of productive asset reserves, and other income-generating expenses. It leads to a decrease in bank income. A decline in bank earnings can affect a bank's performance and can indicate poor asset quality due to banks' reluctance to lend.

Capital Adequacy

According to the findings of this research, it indicates that capital adequacy has a positive significant effect on Islamic bank’s performance (ROA). This finding is consistent with previous studies conducted by (Haidary & Abbey, 2018) who discovered that capital adequacy had a favorable and substantial influence on return on asset. (Stephen Kingu et al., 2018) found that capital adequacy has been demonstrated to have a favorable influence on bank profitability, allowing banks to utilize their own cash to support asset expansion and improve earnings.

Liquidity

This study discovered that liquidity has a considerable negative impact on Islamic bank performance (ROA). The results are in line with research conducted by (Harjanti, 2021) and (Sitompul & Nasution, 2019) that demonstrates that liquidity has a considerable negative impact on return on asset. Due to their poor yield in comparison to other assets, liquid assets impose an opportunity cost on the bank.

Gross Domestic Product

According to the findings of this study, gross domestic product has no positive significant influence on Islamic bank performance (ROA). The result is consistent with previous studies (Stephen Kingu et al., 2018) who found that gross domestic product is not correlated with bank performance / return on asset. Another study conducted by (Usman & Lestari, 2019) found similar results that the GDP growth rate does not influence the bank profitability / return on asset. Because the level of gross domestic product growth rate is an external factor, it does not greatly influence the profitability of banks. This is due to the fact that the gross domestic product growth

rate is the level of state income that does not considerably affect the profitability of banks. However, if a bank has a good internal financial infrastructure, the bank will be unaffected by the gross domestic product growth rate.

Inflation

This study found that inflation has no positive significant effect on Islamic bank's performance (ROA). The result is similar to the study conducted by (Fuadi et al., 2022) who found that inflation had a low or insignificant effect on the return on asset, the result shows that although inflation has increased, the profit earned by Islamic banks does not experience a significant decline and vice versa if inflation decreases profits obtained by Islamic bank did not increase significantly.

Recommendations

It is important to admit that this study does have certain limitations, and it is equally important to offer some suggestions for future research. First, this study is only focused on Islamic banks in Indonesia and does not examine the conventional banks so that the results do not represent the whole bank industry in Indonesia. Hence, to get a better picture for future studies, it can include conventional banks in the research. Besides, it was limited to the number of Islamic banks that meet the criteria used in the study and the financial data of the Islamic banks is 5 years only from 2017 to 2021. It is suggested for the future studies can add more banks and also extend the analyses time to cover a longer period. This will provide a thorough insight of factors that can be a determinant of Islamic bank's financial performance. Despite the fact that this study focuses on factors that have been regularly employed by previous studies to predict bank performance, this analysis discovered that these variables have limited explanatory power. As a result, it is suggested that future studies look for additional specialized bank performance indicators, such as operation efficiency and macroeconomic indicator such as interest rate that may give a better explanation of bank performance.

Conclusions

A better performance is based on bank profitability. It is the profitability factor, in addition to social and environmental factors, that guarantees the bank is sustainable in order for it to be able to function over the long term in order to serve the general public, shareholders, the government, and the economy of the nation in general, as well as other stakeholders in general. This study provides empirical evidence on the factors that can be a determinant of Islamic bank's performance in Indonesia. This study is done by using bank specific determinants such as asset quality, capital adequacy, and liquidity and the macroeconomic determinants such as gross domestic product and inflation. Using a sample of 10 Islamic banks in Indonesia from 2017 to 2021, it is found that asset quality and liquidity is associated with the decline in return on asset, while capital adequacy is associated with an increase in return on asset bank. Therefore, the implication of this finding is the presence of a rate of inflation and gross domestic product has unfavorable impact on the return on asset.

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